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MANAGEMENT SERVICES BY CERTIFIED PUBLIC ACCOUNTANTS
FOR BUSINESSES OF SMALL AND MODERATE SIZE

by

JAMES D. CREELMAN

B.S. Montana State University, 1959

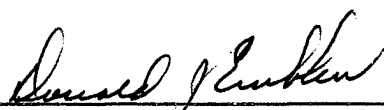
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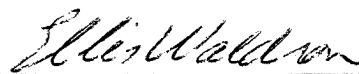
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1960

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PREFACE

The question of whether to render management services is receiving a great deal of attention from the accounting profession at the present time. Many articles have been written on the subject. However, very few of the authors share the same opinion on just what management services are. This study was undertaken due to a desire that the accounting profession achieve the place it has earned in business life by virtue of the high quality of its membership and their willingness to assume self-regulation to insure a continuing high quality of service to business.

As the reading which underlies the study unfolded, it became apparent that the greatest opportunity for service conceivable lay in the current problems of small businesses. Therefore, the possibility of service to this group is emphasized to the exclusion of any other. Small businesses usually receive their accounting services from a local practitioner with a relatively small local practice. Therefore the techniques outlined are intended for this group of CPAs.

Thus the study was impelled to an analysis of both the problems of small business and the possibility of management services by CPAs. Obviously there are serious limitations upon the ability of any one individual to do justice to both these broad, complex problems. However, they are matters which must be considered if a profession is to continue to grow.

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CHAPTER I

MANAGEMENT SERVICES

The field of management services by Certified Public Accountants is a highly controversial one. Professional accountants have difficulty coming to any agreement on just what is meant by the term, to whom the services should be rendered, and whether such activities represent a legitimate accounting function.

This study will point out that a large part of the controversy surrounding management services is a result of a lack of understanding of what these services involve, and that when fully understood this work will offer a challenge to the CPA. In any event, there is a definite need for these management services on the part of small businesses. Since many CPAs are possessed of inquiring minds, it was thought necessary to question the importance of small business enterprises to the American economy, rather than to rely upon the vast quantity of propaganda currently available to establish that small business is indeed important. In addition, if CPAs are to be expected to offer management service to small business, they will want to know what problems they can expect to encounter, and if their efforts can contribute to the solution of these problems. Since no one is completely altruistic, a section explaining the returns that could accrue to the accounting profession and the

individual practitioner as a result of management service is included. This is followed by an examination of the technique of management service in order that the CPA be cognizant of the difference between this type of work and the traditional accounting functions. Finally, the specific management services in which a CPA can legitimately engage are examined and a recommendation made for caution in the early stages of the effort.

Justification for this study is to be found in the tremendous need of small businesses for assistance in improving the efficiency of their operations and therefore the return on their investment, and in the complacency of the accounting profession. Certified Public Accountants as a group have been content to remain relatively uninterested in adjusting the practice of their art to reflect the revolution in business practice, and in most cases have not seen fit to provide small business enterprises with the technical assistance they so badly need.

Advisory service. Arguments against engaging in management services are many and extremely varied as is characteristic of the profession. However, they seem to revolve around differences in opinion as to what is involved in this sort of service, as well as a reluctance to undertake a significant innovation in accounting practice until either circumstances have thrust it upon the profession or the opportunity is lost.

In 1957 the American Institute of Certified Public Accountants conducted a survey of local accounting firms in order to determine what the practitioner thought management services to be, as well as what services were being performed. A list was compiled of 116 items, including representation in each of the following ten broad classifications: (1) finance, (2) general management and administration, (3) office management, (4) purchasing, (5) other professional services, (6) personnel, (7) research and development, (8) traffic and transportation, (9) production, and (10) sales.¹ The list was then mailed to fifty practitioners with the request that they check those items which they regarded as a legitimate management service by a CPA. The replies listed such diverse activities as the development of cost accounting systems, surveys of office space utilization, preparation of job classifications, surveys of material handling techniques, time and motion studies, evaluation of new plant locations, and many more. Obviously some of these activities are completely unrelated to the practice of accounting. It is noteworthy that the only activities which received affirmative answers from more than 90 per cent of the respondents were in the areas of general administration, finance, and control. The Institute clearly took this

¹American Institute of Certified Public Accountants, "Management Services by CPAs, A Survey by the AICPA Research Department," Journal of Accountancy, (June, 1957), p. 45.

revelation to heart because it issued in 1959 four bulletins entitled: (1) "The Concept of Management Services by CPAs," (2) "Budgeting for Profit in Small Business," (3) "Financing the Small Business," and (4) "Cost Reduction and Cost Control in the Small Business."

In spite of the sanction of inclusion of management services as a part of accounting practice by the AICPA, many prominent accountants are unhappy about the prospect of CPAs engaging in this activity. Objections range from the contention that accountants have always performed these functions and the discussion is therefore superfluous, to an expostulation that if these services are undertaken a two-class profession will be created--one class to perform management services, the other to do "write-up," auditing, and tax work.

It may be true that a few highly progressive local practitioners have been performing these management services. However, it would be very difficult to sustain the argument that these represented a majority. Table I, which is reproduced from a study of accounting practice in Montana, reveals the very limited management services work done in that state.²

The charge that adoption of management services as a

²Jack J. Kempner, Survey of Certified Public Accounting Practice in Montana, (Missoula: Bureau of Business and Economic Research, Montana State University, 1960), p. 25.

TABLE I

NATURE OF ACCOUNTING SERVICES RENDERED

	Percentage of accounting service performed in each category		
	<u>All Firms</u>	<u>Large City</u>	<u>Small City</u>
Auditing	22	23	21
No-opinion statements	12	15	5
Bookkeeping or write-up	29	28	33
Tax Service*	29	24	38
Management consulting and system design	3	3	2
Other	<u>5</u> <u>100</u>	<u>7</u> <u>100</u>	<u>1</u> <u>100</u>

*Where tax returns were filed in conjunction with periodic audit or bookkeeping services, respondents were asked to include such classification with either of these two categories.

part of accounting practice would result in the formation of a two-class profession prompts one to point out that accounting is already this sort of a profession. The CPA who is employed by a large national firm practices a far different type of accounting than the small local firm with one, two, or three partners.

The majority of objections to the adoption of management services arises out of misconceptions concerning what the practice of these services involves. These accountants hold the belief that management services include many which require abilities beyond that which can reasonably be expected of a CPA. To the extent that they believe the "Classification" issued by the institute represented a list of management services by CPAs, their objections are legitimate. Actually the replies to the questionnaire circulated with the "Classification" are the significant part of that effort. It was stated earlier that of the firms queried over 90 per cent had performed services in the areas of general administration, finance and control. These areas largely represent uses of accounting data. As the services in the list become further removed from the traditional accounting function, fewer and fewer of the respondents had performed them. In this way the replies reveal what management services the CPA should undertake to perform.

Marquis G. Eaton coined the phrase "the controller-ship approach" to define the management services that an

accountant might perform.³ His concept of the new service was that the CPA should fill the "voids" existing in the management of small businesses. Thus, the independent public accountant would perform for the small business the duties of the controller, which the business could not afford to maintain on a full time basis. This approach will be described more fully as a part of the "Technique of Management Services" in Chapter V. However, it should be noted that budgeting, forecasting, financial management, and cost control are integral parts of the controllership function.

Even when it is understood that management services must be confined to the activities of a controller unless a CPA is specially trained to perform some additional service, other objections still remain. It is argued that the accountant cannot render management service and still remain independent. In this respect it is of fundamental importance that management services remain of a purely advisory character. They must not in any way encroach upon the traditional management prerogative of decision-making. The CPA would certainly lose his last vestige of independence were he to engage in the decision-making function. If his service remains purely advisory, then it may be effectively

³Marquis G. Eaton, The CPA Handbook, Ch. 25, "The CPA as a Business Consultant," (New York: The American Institute of Accountants, 1953), p. 27.

argued that he is simply acting as a source of information and thus retains his independence.

It is interesting to note that the Securities and Exchange Commission agrees in principle with this view on independence. The 1957 annual report of this agency states that:

Another reason for finding a lack of independence in a number of current cases is the fact that some accountants intending to certify financial statements included in such filing have been interested in serving the client's management, or in some cases large stockholders, in several capacities and in doing so have not taken care to maintain a clear distinction between giving advice to management and serving as personal representatives of management or owners, and making business decisions for them.⁴

If the CPA were to actually take over a portion of the management of the firm by way of decision-making, he would incur a legal liability far in excess of that which is now considered slightly worrisome. In addition to these most expedient reasons for maintaining management services on a purely advisory basis, there is the matter of effectiveness to be considered. If the philosophy behind these endeavors is that of helping management gain an insight into the intricacies of its own operation, then they will surely be more welcome from management's point of view. The manner in which the CPAs are received is of

⁴Securities and Exchange Commission, 1957 Annual Report, (Washington: Government Printing Office, 1958), p. 7.

vital importance to the success of the engagement.

Management service is for small business. If the logic behind the concept of the controllership approach is acceptable, then most CPAs can expect to render very little management service to the larger enterprises. These businesses are usually characterized by a large, highly specialized staff. Therefore in all probability there will be no "voids" in their management which could be filled by a "local" practitioner. In addition, it appears to be the vogue in management of large enterprises to retain only the most highly specialized outside counsel, which obviously does not include this type of CPA.

The above generalization concerning management service to large enterprises is meant to apply to the CPA who has experience and formal training only in accounting and related areas, therefore the "local" practitioner. It is well known that many holders of CPA certificates are trained in and highly qualified to render service in problem areas far removed from the accounting function. These accountants will usually be found in the employ of a large national firm, and to the extent that this is true, that firm will be able to render specialized management services to large enterprises. However, these services will remain largely beyond the ability of a CPA without special training.

CHAPTER II

WHY THE CONCERN FOR SMALL BUSINESS?

If the CPA is to devote the amount of talent and energy to the solution of small business problems as this paper would suggest, then he should be vitally interested in the question of whether it is worth the effort. So many authors, among them politicians, economists, and sociologists, have expounded the virtues of small business that it must soon be granted a high place in the national conscience. No political or trade convention closes without confirming that small business is the backbone of the free enterprise economy and the democratic system.

This concern is not new, nor entirely a product of the burgeoning political awareness of the small businessman himself. One of Thomas Jefferson's ideals was that of an economic system characterized by the existence of a large number of small producers--"the independent people." The Jeffersonian ideal referred to the small farmer rather than the small manufacturer or merchant. However, the small businessman has long since replaced the farmer in our ideology. Thus, the small enterprise has become a traditional symbol of independence. This chapter will point out that this symbolism is based on fact, and that small business has an important and useful place in the economic system.

Variety of definitions. One of the most vexing problems in any study of small business is to delimit the field of interest. There are many, many definitions of small business currently in use by government agencies, trade associations, and the small businessmen themselves. The criterion used to define small business in the Senate Bill to "stimulate and increase small business enterprises" was the number of employees, specifically those businesses employing less than 500.¹ It was estimated that at the time this bill passed, it would include all but 0.12 per cent of the business establishments in the country.² The Bureau of Labor Statistics has used the average of some standard measure of output or capacity as the dividing line between large and small in different industry groups. Thus, a small manufacturing establishment is one with less than 43 employees, a small independent retail store is one with less than \$20,000 annual net sales, a small chain retail store is one with less than \$74,000 annual net sales, and a small service establishment is one with less than \$5,000 annual net receipts.³ The Department

¹Senate Bill 1913, 78th Congress, 1st. Session.

²A. D. H. Kaplan, Small Business: Its Place and Problems, (New York: McGraw-Hill, 1948), p. 21.

³Hearings, Senate Small Business Committee, Smaller Concerns in War Production, III, 77th. Congress, 2nd. Session. (1942) Part 12, p. 1743.

of Commerce used criteria similar to those of the Bureau of Labor Statistics with quantitative differences.

It is obvious that efforts to define small business on the basis of quantitative criteria are largely futile. If a definition is to be workable, it must have relatively widespread application, must be easily applied, and for the sake of understanding, it should be brief. After impatiently abandoning a series of definitions as unworkable for the purpose of a particular study, one has a responsibility to formulate another, better one.

The following features distinguish the really small firm: absence of paid labor or its limitation to an assistant or two, direct participation by the proprietor in the work process, lack of any specialization in management and superintendence by the proprietor, restriction of the expansion motive through inability of the proprietor to save, and his primary concern with the production of a family subsistence.⁴ These qualitative measures are useful for arriving at what, for the purposes of this study, must be a subjective determination of what is a small business. While these criteria are useful, they must not remain the only test of what is to be considered a small business for the purpose of management service by a CPA. The concept of the

⁴Joseph D. Phillips, Little Business in the American Economy, (Urbana: University of Illinois Press, 1958), p. 18.

accountant acting as the controller, which the business cannot maintain on a full-time bases, obviously applies to much larger businesses than those which would be included under these criteria. In fact, any business which does not maintain its own specialized staff for budgeting, financial management, cost control, and accounting systems work has need of a management service by an independent CPA.

Thus, any business which does not maintain personnel qualified to perform each of these specialized functions will, for purpose of this study, be considered small. This criterion is not as loose as it may first appear. Any business above what would conventionally be termed intermediate size, must have personnel to perform these functions. Certainly, these duties will not always be dispatched as well as they might be if an independent CPA was retained for that purpose. However, if the firm has this service on a full-time basis with a reasonable degree of efficiency, then for this study, it is not a small business. This delimitation obviously includes some businesses which under conventional definitions are termed of medium or moderate size. In order to avoid confusion, it should be noted that hereinafter the term small business will simply be a replacement of the unwieldy compound term--small and moderate-sized business.

Importance of small business. The Small Business

Administration reports that there are four million small businesses in the United States, which amounts to 96 per cent of all business entities.⁵ Table II is of purely regional interest. However, it does provide a clue to the average size of business firms in the State of Montana. It should be noted that the data includes only those firms which are covered by unemployment insurance. Therefore, organizations which don't have any paid employees, of which there are many, are excluded. On the basis of employment, which is one of the best indicators of the scale of operations, it appears that business in Montana is carried on by relatively small firms.

According to the United States Department of Commerce, 44.5 per cent of the labor force is employed by firms hiring fewer than 100 people.⁶ There should be little question of the importance of any business group which employs nearly one-half the labor force. At the same time, it is of the utmost importance that the economic waste resulting from their inefficient operation and high mortality rate be stopped.

Efficiency of small business. Most authors suggest that while it is difficult to compare the relative

⁵Wendell B. Baines, "Small Business, America's Biggest Business," Nations Business, (April, 1959), p. 57.

⁶United States Department of Commerce, Survey of Current Business, (May, 1954), p. 12.

TABLE II

AVERAGE NUMBER OF EMPLOYEES PER
INSURED EMPLOYER IN MONTANA
FISCAL YEARS 1951-1959

<u>Fiscal year</u>	<u>Number of employers</u>	<u>Number of wage earners</u>	<u>Average no. of employees</u>
1959	14,923	109,408	7.3
1958	14,815	109,069	7.4
1957	16,251	115,899	7.1
1956	15,757	113,896	7.2
1955	15,232	108,048	7.2
1954	14,853	107,018	7.2
1953	14,480	105,838	7.3
1952	14,173	102,926	7.3
1951	14,295	102,853	7.2

Source: Unemployment Compensation Commission of Montana;
Chadwick H. Smith, Chairman.

efficiency of small and large businesses, the smaller enterprise does not accomplish the allocation of resources in a particularly efficient manner. Business efficiency is commonly gauged by the ability to hold down costs and earn a satisfactory profit. Cost records of a small business are often not adequate to effect a reliable comparison with those of a larger unit. Very often the tangible assets of the small business are small relative to the business done, which tends to exaggerate the return on investment even though, in many cases, it is a rather meager living for one family. Another problem is that it is usually difficult to separate owners' salaries and profits, which also detracts from the reliability of any rate of return figure. Perhaps the most serious difficulty is that it is not easy to find both a large and a small firm in the same industry with the data necessary for any comparison. Therefore, any decisions made on relative profitability are often based upon comparisons of heterogeneous units.

The most influential survey, to date, on the relative efficiency of small, medium, and large businesses was conducted by the Federal Trade Commission for the Temporary National Economic Committee.⁷ Data used by the commission didn't involve any new investigation, but comprised

⁷Relative Efficiency of Large, Medium-sized, and Small Business, Monograph No. 13, (Washington: Temporary National Economic Committee, 1941).

primarily an assembly from its own files and those of the Tariff Commission of the studies on variations in cost which had been collected over a period of years. The report concluded unequivocally that large scale enterprise is less efficient than small and medium-sized business. Because of the rather startling nature of this conclusion, and the fact that the report is constantly quoted, a few observations on its veracity are in order.

The study did not attempt to allow for the influence of those factors, other than size, which might have influenced the results. Thus, factors such as: operation in different industries and different regions, comparisons taking place often at widely separated points in time, shifts in centers of population, exhaustion of natural resources, and changes in government policies were minimized. The influence of these factors was waved aside with the statement that:

It would be unreasonable to assume that the more effective performance of medium-sized and small business units in many industries could be solely the result of factors which lay beyond the control of management. Such factors are likely to effect all enterprises, regardless of size, and are not likely to be statistically biased in favor of any one size classification against another.⁸

The fact is that these differences which are beyond the control of management do have a very profound effect upon the results of any business operation. Moreover, this

⁸Ibid., p. 3.

effect will often vary with the size of the firm. The difference between a large and a small firm is not simply a matter of degree as the commission apparently assumes. An important difference in kind is revealed by the fact that many small business failures take place in industries dominated by one or a few large producers, and that new small businesses are often of the ephemeral gadget-producing variety. In this way, it appears that small business is being removed from competition in certain industries. The F.T.C. study does not take this fact into account.

The study used unit cost figures as an important criteria of efficiency. However, no allowance was made for the level at which operations were taking place in relation to full capacity. As a result, the conclusion that smaller firms operate more efficiently was based upon a \$1.14 unit cost for a small cement company operating at 100 per cent capacity, compared with a unit cost of \$1.20 for a large producer operating at approximately 60 per cent capacity.⁹ This comparison certainly does not add to the credibility of the conclusion that small business is more efficient than large.

Subsequent studies have suggested that the F.T.C.

⁹R.C. Osborn, "The Relative Efficiency of Large, Medium-Sized and Small Business," Accounting Review, (July, 1950), p. 262.

conclusion was something less than accurate.¹⁰ This seems entirely possible in view of the fact that no effort was made to draw a representative sample. Instead, existing records were perused for examples of what was needed. In addition, many important variables were ignored. It is unfortunate that this study was not conducted on a higher plane, especially in view of the fact that its results appear to have been widely accepted. It is obvious, that in spite of any pretensions by the F.T.C. to the contrary, a definitive statement on the relative efficiency of small business is still wanting.

The following observations have been summarized by A. D. H. Kaplan from various studies of efficiency by size.¹¹

1. The differences in efficiency among the small enterprises themselves are more extreme than those between small and large firms.
2. The over-all tendency is for unit costs to diminish as size increases until the big business category is reached. But the very largest member of an industry does not usually show the lowest cost or the best profit rate on invested capital. In

¹⁰John M. Blair, "The Relation Between Size and Efficiency of Business," Review of Economic Statistics, Vol. 24 (1942) p. 125.

¹¹A. D. H. Kaplan, Small Business: Its Place and Problems (New York: McGraw-Hill, 1948), p. 80.

most cases a firm in the middle range makes the best showing.

3. The relative profitability of small and large business changes markedly as the general level of business activity changes. The profits of small businesses tend to rise more sharply than those of big business when general conditions are improving. Conversely, in a recession the drop in profits and the increase in the percentage of deficit firms is more abrupt for small than for large businesses.
4. The disparity between the most profitable and the least profitable firms is relatively much greater for small firms than for big business. The percentage of deficit firms is notably greater in the small-business brackets than in big business. In "normal" years, when medium-size and large businesses were showing a good average rate of return and a few well-managed small units were profitable, the number of deficit corporations in the lowest size bracket was sufficient to create a net deficit for the small business group as a whole.

These statements, with the possible exception of the last one, are largely inconclusive. The last statement suggests what may be the difficulty with the others. It uses

a method which takes into account the amount of deficits involved, and is therefore something of a weighted-average approach. The first statement may confirm the fact that in the aggregate the uneconomical operations in the small business category outweigh those in big business. This is particularly noteworthy in view of the fact that a single bankruptcy in big business will involve many times the amount of outstanding liabilities encountered in a small business failure. The sharp reverses in profitability of small businesses at the time of an economic downturn would indicate that marginal and submarginal business operations are to be found in larger numbers among small businesses than their larger counterparts.

Mr. Kaplan marvels at the number of small firms which were able to "pull out of the red" in one or two years with the upturn after 1939.¹² He suggests that this is probably a result of the highly touted flexibility of the smaller enterprise. However, it is more likely that the real reason for this rejuvenation was that many small businesses are potentially profitable, and an impetus in the direction of a more informed management would pay dividends in improved financial condition and more efficient operations. Certainly the survival and eventual recovery of even a few small businesses should prove that they have a place in the

¹²Ibid., p. 102.

economic system.

The distribution of economic power. An important consideration, but not so amenable to quantitative analysis as those preceding it in this discussion, is the maintenance of a wide distribution of economic power. Many very astute economic observers believe that this one factor is of overriding importance. Thus even if small business were grossly inefficient and unprofitable, it would be worthwhile to maintain its existence if only to avert a large scale concentration of economic power. The results of such a concentration of power are largely common knowledge. They involve higher prices, a scarcity of goods and services, and an increasingly uneven distribution of wealth.

If the specter of big business is not enough, then there is big government which experience teaches is the counterpart of the development of big business. One power-block seems to have spawned another until small business is left as the only relatively unadministered sector of the economy. It is worthy of note here that the Small Business Administration is currently spending hundreds of thousands of dollars to see if anything can be "done for small business." So even the small enterprise may come under the purview of the regulator.

It is likely that the maze of small business enterprises will remain as the section of the economy least

amenable to centralized control. In serving its own interest, small business serves as a social and political stabilizer, its very numbers acting as a safeguard against concentration of power in any one group. It is hard to contemplate a vigorous middle class or a strong nucleus of independent voters without the small business element. Thus an argument unfolds for the maintenance of the small business community simply because it is a desirable way of life. This is not an economic argument, and it does not have the logical appeal to be found in economic theory. However, it has obvious merit.

On balance, it appears that many of the conclusions now available concerning the relative efficiency of small business have serious limitations. They often rely upon empirical data which is wholly inadequate. Research methods in this particular social science have not as yet effectively made allowance for distortions resulting from the lack of uniformity in accounting methods, differences in geographical position, varying accessibility to raw materials and transportation facilities, and product variation. Comparisons of relative costs and profitability have been necessarily confined to a sample of situations in which a representative number of companies in all classes deal with the same commodity. This leaves a relatively few industries from which to derive a sample, and therefore draws distorting influences from the peculiarities of each industry. On the

other hand, it would be statistically unsound to compare large, medium, and small businesses drawn from different industries.

In spite of these qualitative limitations upon the statistical approach to any efficiency comparison, there is some evidence that small businesses as a group are in a less sound financial position than are the larger enterprises. The consideration of the aggregate amount of deficits between the two size classes is particularly significant in this respect. In any event there appear to be strong social as well as economic reasons to insist that the small business enterprise remain a part of economic life. If this is so, then any professional group, such as the Certified Public Accountants, which is in a position to increase the efficiency of small business and improve its financial stability, has a pressing responsibility to do so.

CHAPTER III

THE PROBLEMS OF SMALL BUSINESS

It has been established that the small business enterprise has a definite place in economic life. A case has been made for the contention that small business is neither as financially sound nor as efficient as big business. Now it remains to determine just what the problems of small business are, and how the CPA can alleviate them through management service.

Classification of problems. The Department of Commerce uses a useful classification of the causes of small business failures.¹ First, there are the "immediate" causes of failure. These are the factors which aggravate long standing difficulties to the extent that continued operation becomes impossible. In any particular instance, an immediate cause might be an increase in the rent, a rise in labor costs, or a decline in value of inventory. These factors are in the main environmental, and reflect the characteristics of the current business situation. Secondly, there are the "fundamental" causes of business failure. These are attributes of unsuccessful concerns such as inadequate record keeping, inexperienced management, poor

¹"Business Turnover and Causes of Failure," Survey of Current Business, (April, 1947), p. 10.

location, etc., which make them especially vulnerable to the environmental factors described above. These characteristics are related primarily to the problems of business practice, and in a sense provide definitions of the "marginal firm." There are of course always such marginal firms--high-cost, inefficient, or otherwise handicapped concerns--and their emblematic attributes do not vary much over time. The fundamental causes of failure in this sense are ever present. It is the immediate causes which from time to time activate them and transform marginal firms into failures.

The fundamental causes of difficulty in small business are the paramount concern of the CPA who wishes to render useful service to these enterprises. Naturally, he will often be called upon to solve some problem arising out of one of the immediate causes of difficulty. However, even if he is sufficiently skilled to overcome this obstacle, the real cause of trouble will remain. Therefore, it is always the accountant's responsibility in cases of this nature to isolate the fundamental difficulty, and to the best of his ability, eliminate it.

It should be noted at this point that the Small Business Administration, various trade associations, and many of the major philanthropic organizations are expending vast quantities of money and talent in an effort to isolate the fundamental problems underlying the difficulties of small business. Therefore, it would be most pretentious of

the author or any individual CPA to claim to have complete knowledge of the causes underlying the current difficulties of small business. Nevertheless, some generalization concerning these causes must be made if management service is to accomplish all it can.

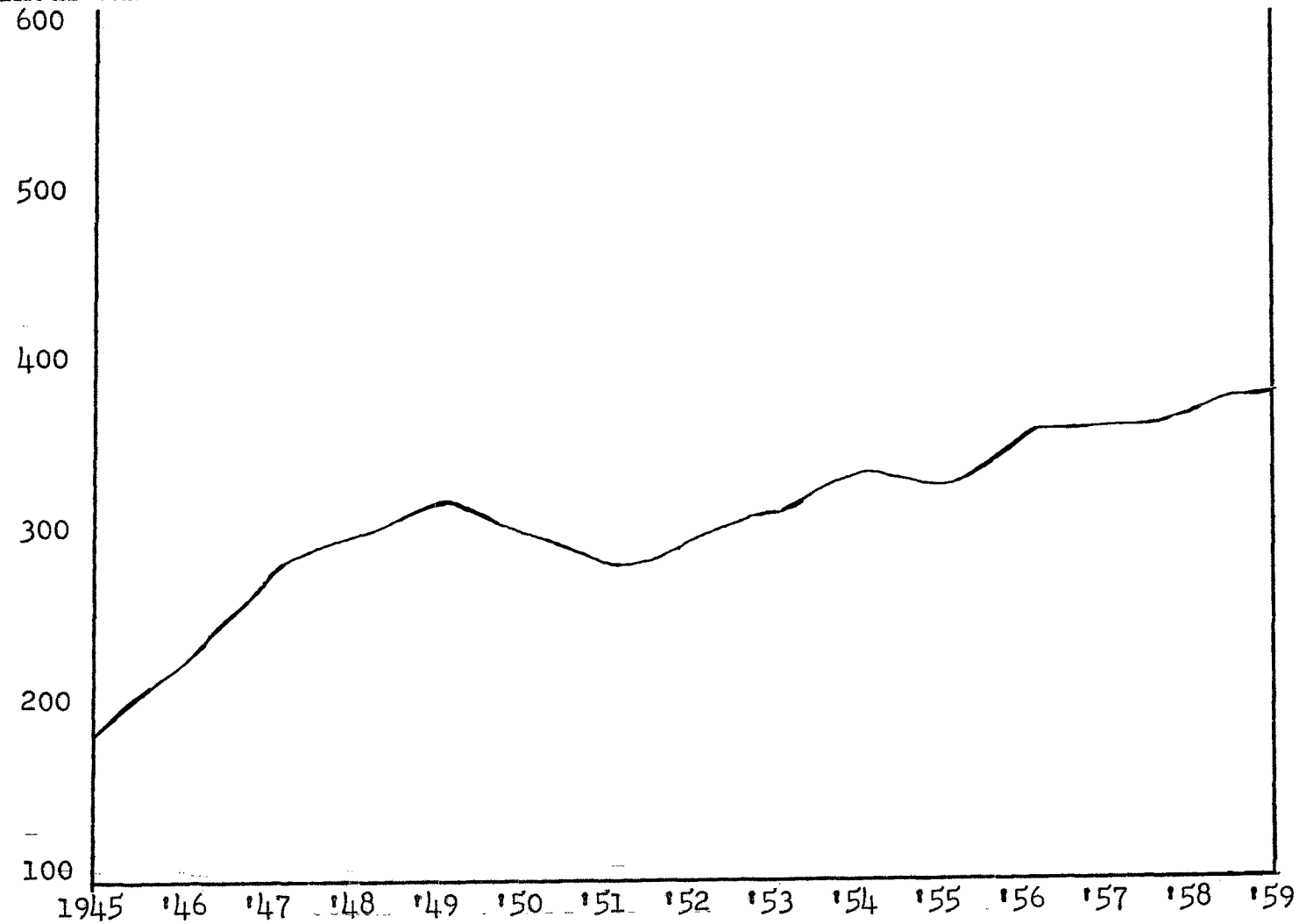
Managerial deficiencies. Dun and Bradstreet reports that 90 per cent of the small businesses that fail do so as a result of managerial inexperience and incompetence.² The above figure is more alarming when viewed in conjunction with Chart I, which graphically illustrates the climb in the rate of business discontinuances since the end of World War II. It is clear that small business is in need of help. However, as was suggested in Chapter II, it should be the kind which helps the small businessman help himself. This is precisely the sort of help a Certified Public Accountant is equipped to give.

It is not enough to simply say that managerial inadequacy is the biggest problem that faces a small business. A second generalization will help somewhat to define the specific areas of the management function in which the small entrepreneur is found lacking. The small businessman does not know enough about his business, past, present or future.

²"Big Problems of Small Business," Management Review, (January, 1957), p. 42.

FIRMS DISCONTINUED

Concerns in
Thousands



Source: U.S. Dept. of Commerce, as reproduced in
Dun's Review & Modern Industry, July, 1960

It is common practice for a small businessman to refer with pride to the number of years he has been in business, implying that his accumulation of business knowledge is second to none. In many instances the business under this man's guidance has survived more as a result of a series of fortunate guesses than an enlightened choice of alternatives. This is definitely not true of all small businessmen, but is surely characteristic of the majority of those involved in the so-called marginal operations. Many such an operator does not have a record keeping system which will enable him to evaluate the interactions among the multitude of variables, both internal and external, which are involved in the operation of any business. Thus the experience he feels he has acquired is largely a myth insofar as he is able to draw on it to facilitate effective decision making in the present. If a businessman does not understand the future effects which will result from decisions made in the present, he is actually allowing circumstances to make those decisions for him.

Intelligent decision making is the essential management function. A wise decision is simply the choice of the most advantageous alternative from all those facing the business at any point in time. In order to make the best choice, a manager must know what alternatives are available to him, and all the ramifications of each one. It is almost impossible to effectively manage without this knowledge, and it is relatively impossible to accumulate and

use this knowledge to advantage without the various tools and techniques such as budgeting, cost control, record keeping systems, and financial management. It is the accountant's function to make these devices available to the small business.

Financing and taxation. Difficulty in acquiring capital, either equity or borrowed, is often cited as a small business problem. A businessman who does not have a sufficiently accurate picture of the condition of his affairs to understand why he has need of funds, or how he can best apply them, will find it difficult to acquire capital. At the same time, such a management will more often have need of externally derived funds than one which is fully informed of its operation.

It is almost axiomatic that any item of expense which is not under constant scrutiny will trend upward. Thus, a businessman who lacks the information necessary for effective cost control will find profits diminishing. As this process continues he will find it increasingly difficult to operate on self-generated working capital. Moreover, if he has not planned in advance for periods when operating funds will be seasonally scarce, any working capital which was internally produced may have been put to other uses. As a result of this vicious circle, the businessman may find himself applying for a short-term loan even though he is not sure of how much he needs or for how long he will need it.

Banks are extremely reluctant to grant credit to any business entity the management of which is not fully informed of its operating and financial conditions. Lack of this information is a reflection of poor managerial ability which is always an important consideration to a bank. In addition, if no reliable budget or forecast of the future business activity is available, the bank has little or no cause to believe that they will be repaid. The small businessman often applies for "just enough to tide me over." This makes it clear that the proceeds of the loan will be applied to the liquidation of currently maturing liabilities. A responsible banker is usually quite justified in refusing to grant a loan of this nature both because of the relatively high risk involved and also, in many cases, it would just tend to prolong the agonies of a sub-marginal operation.

If he does not care to borrow funds, or in the event that he is unable to do so, the small businessman may consider raising equity capital in order to finance current operations, or to finance an expansion or replacement program. First of all, many small entrepreneurs are extremely reluctant to allow anyone else a voice in the management of the enterprise. To the extent that he will not allow this participation, most sources of capital, with the possible exception of friends or relatives, will be closed to the small businessman. When the limited funds available from these personal sources are exhausted, he usually finds it

impossible to raise capital through any organized securities market without giving up some of his control. Even if he is reconciled to the necessity of sharing control, the small businessman will often find acquisition of capital through the security markets prohibitively expensive. The informed investor is extremely hesitant to place his funds with an unknown, unproven firm and one which is highly dependent upon the health of a single individual for its existence. Thus, it is much more difficult for the broker to "move" the relatively small issue. Many brokers will not handle a security issue below a certain minimum (often \$500,000), which is far above the needs of the small businessman. If and when a broker is willing to handle a small issue, his commission will be high in order to cover expenses. When the broker's fee is added to the other costs incident to entering the securities market, such as auditor's, appraiser's, and lawyer's fees, the process of raising money is found to cost more than the business can earn on the funds thus derived.

The efforts of a CPA will not be such as to correct the difficulties of the small business which are inherent in the character of the financial markets. However, to the extent that his management services are able to improve the quality of management, he will have improved the quality of the small business as a credit or investment risk. Whether or not the banks will be willing or able to supply all the

funds needed by even the best small business credit risk is as yet a moot question. A study by the Board of Governors of the Federal Reserve System suggests that the short-term requirements of small business are being provided for, but that there is a definite lack of intermediate and long-term financing available.³ Therefore, a part of the accountant's responsibility in management services is to arrange as best he can, that requirements for funds will be largely of a short term nature. It is possible that when a local bank has a period of profitable, safe experiences on short-term loans, and is aware that a competent financial counsellor, in the person of the CPA, is connected with the small business, it will be willing to provide funds for longer periods.

Another factor often cited as inhibiting the development of small business is the progressive income tax. Here again the efforts of any individual CPA will not be able to correct any inequities supposedly existing in current tax legislation. However, by paying constant attention to the effects of any current acts and decisions upon the annual tax liability, it will often be possible to reduce that liability.

³Federal Reserve System, Financing Small Business, A Report to Committees on Banking and Currency and the Select Committee on Small Business, United States Congress (Washington: Federal Reserve System, 1958), p. 54.

Application of the principles of tax minimization, of which every CPA is well informed, on a day-to-day basis, can often reduce the tax to be paid. As well as this valuable tax counsel on a continuing basis, the CPA can render important advice on the tax aspects of: setting up or liquidating a business, the buying and selling technique which will minimize tax, the advisability of accumulating or distributing past earnings, and the least expensive way to provide for the perpetuation of the business. To the extent that these efforts of the CPA are successful in reducing the tax liability, management will be able to satisfy more of its fund requirement out of current earnings, thereby reducing the necessity of externally derived funds.

Internal improvement. The financial and tax problems of small business are at least partially caused by conditions outside the control of the business enterprise. Another problem of small business which receives a great deal of attention is the inability of many of these businesses to sustain an effective competitive effort. Although many of the proponents of "aid to small business" will not agree, the only realistic conclusion concerning the competitive ability of many small businesses is that their disadvantage stems from internal inefficiencies rather than any external influence. This obviously is not true in those industries in which there are significant economies to be realized from large scale operation. However, in many parts of the service

and trade industries, the lower overhead enjoyed by a small operation more than offsets a higher direct unit cost resulting from operating without a high degree of mechanization. This forces one to the conclusion that to provide any sort of subsidy, direct or through tax relief, would be coddling many businessmen who don't deserve it. These people obviously should have help, but it should be of the variety that encourages self-improvement rather than rewarding inefficiency.

Initiation of the small businessman to the uses of budgeting and the various cost control techniques is an example of aid to self-improvement. After he is made fully aware of the possibilities for improvement of his operation through the use of these devices, the responsibility to actually do so is his.

Assuming satisfactory demand for the product or service offered, a primary reason for competitive success of any business is a constructive concern over costs as exemplified by a continuous effort to keep them down. Characteristically, cost control in the small enterprise is of a rough, intuitive nature. The management is continually involved in so many routine authorizations, reviews, approvals, and often actual production that there is no time left to devote to control activities. The possibility of management by exception through the functioning of a semi-automatic system of internal control is often unknown. This type

of small business management does not often have the sort of background that is conducive to "figure consciousness," and therefore does not have even the rudiments of the specialized knowledge necessary for effective cost control, or even worse, is unconcerned about it.

The concept of control in a business enterprise also includes provision for its future welfare through forecasting and the budget device. This aspect of control appears even more nebulous to many small entrepreneurs than cost control. Even though a highly sophisticated type of forecast and budget is not necessary, they are often not prepared because management either lacks the facts to do so or is impatient with the intangibility of such devices. Often a capable management which has a great deal of useful experience and therefore is imminently qualified to make effective forecasts, will hesitate to do so due to a lack of understanding concerning the value of overall planning.

Conclusion. It is suggested that managerial inadequacy arising from a lack of knowledge of the principles of scientific management including budgeting, cost control and financial management, is the fundamental problem of small business. This situation is of course complicated by various external influences over which management has no control. These external problems include, the difficulty of financing day-to-day operations and expansion, as well as the impact of progressive taxation of earnings. No

effort is made here to dispute the contention that it is more difficult to finance the small operation than the large, or that the income tax reduces the possibility of financing from retained earnings. However, it is suggested that the difficulties resulting from these pressures can be reduced by some of the management tools available through the CPA. In addition, the small businessman will find his ability to compete effectively with better-managed and larger concerns greatly enhanced by the use of these same techniques.

CHAPTER IV

WHY SHOULD THE ACCOUNTING PROFESSION RENDER MANAGEMENT SERVICES?

Some of the controversy surrounding the question of whether the public accounting profession should engage in management advisory service was suggested in Chapter I. The two succeeding chapters suggested that small businesses are an important part of American economic life, and outlined some of the problems confronting these businesses. The character of the problems indicates that the experience and training of a CPA could prove invaluable to the management of a smaller enterprise if the accountant should see fit to expand his services. This chapter represents an effort to evaluate the results of such an extension of the accountant's service.

Some of the advantages which would accrue to the small businessman as a result of competent management service were suggested in the last chapter. However, they will bear repetition at this point if only for emphasis. If the CPA fills the "voids" in the knowledge and skill of management, and carries on a process of training management in the use of the techniques which he provides, the effect will be a general upgrading of the quality of small business management. As small businessmen begin to approach their problems in a scientific manner through the use of modern

management techniques such as budgeting and cost control, their operating efficiency will increase followed quickly by an increase in their rate of profit. This change would improve the competitive position of small business, as well as reduce the difficulty currently encountered in raising capital. If such a revolution were to take place, it is entirely possible that the current pleas for aid to small business might disappear because the small businessman would be helping himself. This of course represents the ultimate objective in the extension of management services, and is not likely to be achieved in the near future. However, it is possible if an adjustment in the financial markets takes place which will ensure adequate financing for deserving business.

Gains for the accounting profession. The accounting profession stands to realize significant gains from assumption of the responsibility for management advisory services. Management service is relatively difficult and requires greater knowledge of the techniques of modern management than do the traditional public accounting duties. It is obvious that there is nothing but his own conscience to stop anyone with a CPA certificate from attempting the most difficult management services engagement. Unfortunately, not all holders of such a certificate possess the ability requisite to render high caliber management advisory service. However, this situation will have a tendency to correct

itself. The greater challenge and dramatic appeal of this type of service will attract high caliber personnel into the profession and retain many of the very able younger members now being lost to other fields, especially law and economics. An improvement in the quality of entrants into the profession will have a tendency to encourage greater effort from the established members.

If the profession enjoys a measure of success in management services work, it will enjoy increased prestige in the business community. Contemporary literature is noteworthy for its lack of reference to the professional public accountant as anything but a "checker" and a "verifier" of financial records. Contemporary business management does not feel that the independent public accountant is so far removed from the stereotype of the green eyeshade and the quill pen as he might like to believe. This is most unfortunate in view of the fact that the majority of CPAs are mature, able men fitted by training and experience for much more useful service. Management advisory services offer the profession a chance to demonstrate to the business community that auditing and tax work represent only a part of the capabilities of the accounting profession. To the extent that the CPA can become identified with the creation of revenue or the profit motive, rather than simply being another expense of doing business, both his prestige and opportunity for enrichment will be enhanced.

Business problems and business methods have undergone fantastic changes in the years since World War II. During this time the accounting profession has been kept busy by a rapid increase in demand for auditing and tax work. This demand has been so great that very little concerted effort has been directed toward the "modernization" of accounting principles and procedures to keep up with new problems facing contemporary businessmen. In the last few years the professional literature has begun to devote a large share of its space to discussion, pro and con, on the advisability of abandoning certain traditional methods in favor of others which would supposedly reflect present conditions more accurately. If the CPA were to place himself in management's position, as he must in a management services engagement, it would surely improve his perspective when viewing the management uses of accounting skills and data. In this way, management services might provide the impetus needed to return accounting to its place as a fundamentally utilitarian science.

Gains for the practitioner. The far greater knowledge and better judgment required for management service have already been mentioned, as has the fact that in such an engagement the CPA will be directly identified with production of profits. Add the fact that each engagement is unique and of a highly personal nature, and it becomes obvious that much higher fees will be forthcoming from

management services work. Thus the practitioner who is competent enough to render management services to a firm on a continuing basis and acquire new clients as a result, stands to receive a higher monetary return for his work than one who does not enter the field. Fortune magazine has estimated the gross annual fees for management consulting to be \$400 million.¹

Another important return to the management services practitioner is the often overlooked or downgraded psychic reward. This is often an extremely important matter to an intelligent, responsible individual. Upon completion of a management services engagement, the realization that he has met the challenge of an extremely difficult but beneficial assignment, should provide an ample psychic reward.

If the knowledge that they have the abilities which small businessmen desperately need to improve their lot does not provide CPAs an incentive to enter the field of management services, there are sufficient monetary and psychic rewards to make it worth their efforts.

Will they be successful? An examination of the characteristics of the CPA which fit him for management service will give some insight into the probability that

¹R. Little, "Why Companies Sell Out," Fortune, LIM, (February, 1956), p. 117.

the profession will enjoy success in the field. It is widely accepted that small business management needs outside counsel in order to raise its level of performance. This counsel is becoming increasingly available from management consultants, bankers, trade associations and suppliers. Often, both the small businessman and the accountant are doubtful that the CPA is in fact the individual best suited to render this service. The following analysis will point out that the relationship between the CPA and the business imminently qualifies the accountant to render a high caliber service at a relatively low cost to the business.

The wealth of information on the peculiarities of a particular firm which an accountant gains from his auditing and tax work are of vital importance to his work in management services. To render an equivalent service, another consultant would have to begin with an extensive management survey in order to gain this information. It is the expense involved in this lengthy investigation of the firm's affairs before actual work can begin that places the work of many competent management consultants beyond the reach of most small businessmen.

The fact that the management advisory service is the only income-producing activity of the conventional consulting firm also forces them to charge higher fees than the CPA. The fee charged by a consulting firm must be

sufficient to pay for the idle time experienced between engagements. The busy public accountant will not, in all probability, have any idle time between management services engagements. He will still have auditing and tax work over which he can spread the cost of maintaining an office and a professional staff.

An extensive knowledge of accounting principles and procedures is invaluable in performing the majority of management services in which an outside consultant may legitimately engage. An outside consultant is visualized in this context as an individual who is prepared to study and recommend changes in general administration and control, rather than a highly specialized personage such as the personnel or marketing consultant. Since it is the accounting function to record, report, and interpret the results of business activity, anyone approaching an analysis of the control function would be severely handicapped without this knowledge. A business consultant without a knowledge of accounting would be approximately as effective in his work as a secretary of state who didn't understand the native language. The complexity of modern accounting makes it very difficult to achieve a satisfactory degree of proficiency in the art without years of study and experience. Most management consultants who are prepared to serve small business regard accountancy as an avocation rather than an indispensable tool. Moreover, it is simply too expensive

for most of these practitioners to hire a full time accountant.

An accountant has a ready-made laboratory in his present practice. Constant contact with both the best-managed businesses and poorly managed ones is valuable experience upon which to draw when making recommendations at the conclusion of a management services engagement. Although similarities between businesses can be over-emphasized to the jeopardy of the engagement, there are enough common characteristics that if the experience in one business is carefully applied to another, many pitfalls may be avoided.

The psychological bent of the small businessman often prevents him from getting the management guidance he needs. He has chosen to be his own boss partly because he wants things his own way and is often impatient of formal controls. Almost to a man, they have high confidence in their own ability. This feeling causes the small businessman to attribute his difficulties to almost anything except his own short-comings. This places the accountant in an excellent position relative to that of another independent consultant. As he carries on auditing and tax work for a client, the CPA will often encounter problems of which management is unaware. Thus, as he continues with his other work, the accountant can often prepare the way for a management services engagement. He may point out problems and

suggest tentative solutions without management becoming aware that he is advocating a type of service which the businessman needs but which he would be hesitant to ask for. The prestige now enjoyed by the accounting profession will also facilitate this transition. Many small businessmen, who would speak derisively of a management consultant as an impractical braintrust, are accustomed to listening to suggestions made by their CPA. Thus it is in many ways easier for the accountant to make a management services engagement for himself than it is for the consultant, in spite of the fact that the latter is free to advertise.

Finally, because of his recurring visits to perform other accounting functions, the CPA is in an advantageous position to follow up his management services recommendations. Because the CPA is presumably there to do something else, there will be less of an attempt by management to set up a good show for him. That is, he will be more likely to see a true picture of the results of his recommendations than the consultant who must make a visit especially to examine the results of his work.

Limitations on the CPA. While it is clear that the CPA enjoys many advantages over other business consultants, there are also some factors that are on the side of the consultant. There are significant limitations imposed upon the CPA by his Rules of Professional Conduct. He cannot

advertise his professional attainments, nor even the fact that he is prepared to perform management services. This is not a particularly serious limitation for the resourceful practitioner.

The following chapter suggests that his present clients will keep him busy for some time. The CPA cannot accept an engagement on the basis of a contingent fee. This may prove to be somewhat of a disadvantage since it would be much easier to convince a skeptical manager of the value of management services by agreeing that if he didn't derive obvious benefit, a reduced charge could be arranged. The fact that a CPA cannot formally lend his name to any forecast, even if he prepared it, could in some cases prove to be a disadvantage. If a CPA has prepared a sales forecast from historical data and adjusted it for future behavior of the economy as indicated by various reliable indices of economic activity, it could be very useful in obtaining a loan. However, since the accountant cannot allow his name and reputation to enhance the credibility of the instrument, its utility may be reduced.

In addition to the ethical limitations, there are some very real practical limitations upon the extension of management services. An accounting firm whose clientele is predominantly small business is often relatively small itself, and its partners and staff often have somewhat narrow backgrounds. This will limit both the number of

management services the firm can render, as well as the quality of each. It is entirely possible that many small accounting firms will be just as short-sighted about management services as are their clients. Thus, a serious limitation upon the extension of this service to the small businessman could result from the reluctance of the CPAs to undertake the study and hard work involved in advisory services. In other cases, even if a practitioner is willing to expand his service, he will be burdened with too many clients and too much work to devote the necessary time to management services.

On balance, it appears that if CPAs are willing and able to enter the field of management advisory service, they will in most cases render a valuable service at a reasonable cost, while realizing for themselves an increased monetary and psychic return.

CHAPTER V

THE TECHNIQUE OF MANAGEMENT SERVICE

Assuming a satisfactory level of competence, the success of a management services engagement will usually depend upon the manner in which the CPA approaches the work. This is true both in terms of success at arriving at the proper conclusions concerning a particular problem, and getting the resulting recommendations accepted by management. Thus, to be successful the practitioner must develop a definite technique, some aspects of which will be new and different from the usual approach to an accounting engagement and others which will not. Problems will be encountered in "selling" the service, in human relations, and in the readjustment in viewpoint which the accountant must make. None of the problems likely to be encountered in the performance of management services will be insurmountable if the accountant brings a high degree of skill and sufficient finesse to the engagement.

In spite of the fact that "selling" is officially a bad word, in so far as professional accounting practice is concerned, the CPA must still carry on some subtle form of solicitation if he is to expand his services.¹ This is not

¹Rule 7 of the Rules of Professional Conduct adopted by the American Institute of Certified Public Accountants reads: "A member shall not directly or indirectly solicit

to say that he should undertake the clandestine distribution of postcards ennumerating the management services which he is willing to perform. There are much more effective ways of letting the business community know that a new type of service is available from the CPA with whom most have had contact.

The CPA, whose practice serves small and moderate-sized businesses, is in a unique position with respect to management services. His clients have a vast need for advice in those areas which are closely associated with accounting. Therefore, the most fruitful approach to service in this area would be to carefully analyze the needs of present clients. Usually, in cases of a continuing association with a client, the accountant has noted many causes of operating inefficiency, and has often wished that he could dig into the problem and straighten it out. After the areas of potential service have been pinpointed, the formal approach may begin with a letter to each client simply informing him of the accountant's willingness to engage in management services. There is no rule against writing present clients a letter, or for that matter soliciting them for additional work. The letter should be

clients by circulars or advertisements, nor by personal communication or interview not warranted by existing personal relations, and he shall not encroach upon the practice of another public accountant. A member may furnish service to those who request it."

followed by a personal visit to the client's establishment and tactfully (depending on his personality) discussing the possibility that he may realize substantial benefit from some management service.

For expansion of management services to new clients, while conforming to the Rules of Professional Conduct, the CPA must depend upon word-of-mouth advertising. It is to be expected that the news of a successful management services engagement will soon pervade the small business community. In addition, the practitioner should at every opportunity expound upon the concept of management services--not his own service in this area, but the possibilities of benefit from this service. Often the CPA serving businesses of small and moderate size will have opportunity to speak before civic groups and businessmen's luncheons, which will afford an excellent opportunity to disseminate such information. A forced reliance upon these methods of acquiring new clients is apparently not regarded as a disadvantage. In fact, with very few exceptions, CPAs seem to agree that the best source of engagements in this field, as in auditing and tax work, is by recommendations of clients and friends.²

Sometimes the accountant will not have to engage in any of these methods to acquire a commission to perform

²Perry Mason, "Management Services by Local Practitioners," New York Certified Public Accountant, (October, 1958), p. 707.

management services. In many cases he will be requested to do so. This is especially true in cases where there has been a relatively long business relationship between the CPA and client.³ Very often in this situation an excellent rapport has been built up which encourages the client to approach the CPA with problems of almost any description. The accountant's part in building up this mutual trust appears to be that of bringing a business-survey approach to the routine audit or tax engagement. Therefore, even in cases where the accountant has been requested by management to perform a particular management service, the initiative has remained his by virtue of the sincere interest he has expressed in the general welfare of the business.

It is important that the accountant desiring to perform management services avoid using any semblance of "high pressure" methods in convincing a business management that it needs such service. Since the success of any management services engagement depends upon the goodwill of those who must implement the accountant's recommendations, it would be foolhardy to "convince" them against their will that this or that help is needed. The tendency on the part of the client would be very strong to prove the CPA wrong by having his suggestions fail. It should be noted that what will be

³The author's opinion on this point was corroborated in an interview with a prominent CPA whose practice in Helena, Montana, involves a great deal of management service.

construed as high pressure technique varies with the personality of top management.

New perspective. In order to effectively engage in management services, the CPA must develop an approach involving a much broader perspective than that required to simply establish the integrity of recorded financial data. This new perspective must, for the duration of the engagement, be that of a controller. The following descriptive quotation concerning the duties of a controller expresses very well what must be involved in the approach to management services.

We can define controllership as the coordinating function in a business, working in a detached and unbiased way, and charged with the responsibility of planning for profits and providing suitable profit control machinery. It is the investigative, analytical, suggestive and advisory function, studying the business at all points all the time, and formulating what the proposed practice should be with reference to sales and production control as well as financial control, which when accepted or modified by the executive management, becomes the approved practice for use by the performance or "line" function.⁴

Thus the CPA on a management services assignment should be interested in, and must assess the efficiency and integrity of the entire business operation, not just the recording and reporting function. This does not mean that the accountant must also be a salesman, an engineer,

⁴John H. MacDonald, Controllership: Its Function and Technique, (New York: Controllers Institute of America, 1940).

and a member of whatever other occupational group the particular business employs. Rather, he must possess sound business knowledge as well as an accute business "instinct." Combine these intangibles with the accountant's skill in analytical reasoning and financial control, and the CPA is revealed as having the potential for important service to managements which cannot afford a full time comptroller.

An important part of the above quotation is that which establishes the fact that the comptroller performs a "staff" rather than a "line" function. His job is to (1) acquire complete information on all the ramifications of a particular problem, (2) come to conclusions, based upon this information, as to the best means of alleviating the difficulty, and (3) make suggestions to management on how to accomplish this renovation. Clearly, the decision as to the desirability of the suggested changes is still a responsibility of management. Therefore, the work of the accountant in this situation is to be regarded as complimentary to that of management.

In order that his work may be of this character, the accountant must recognize that a transition has taken place from his traditional responsibility to third parties. In management services work, his responsibility is to the management group, in that his function is no longer that of performing an independent "check" on the stewardship of

management. While this is true, it still remains necessary for the CPA to remain objective and free from bias in his investigation. The use of the latter term should, in this case, refer to a professional bias. That is to say, he should avoid any tendency to view the various functions within a business enterprise as incidental to the recording and reporting function. In point of fact, however great its service through improvement of operations, the recording process is incidental to the line functions. The CPA would do well to keep this fact in mind when dealing with the many human relations problems which are a part of many management services engagements.

Human relations in management services. Human relations problems arise at every stage of a management services engagement--securing and planning the engagement, carrying out the investigation, and presenting the findings and recommendations. Each of these problems must be overcome by process of mutual understanding, since the CPA is in no position to invoke any sort of authority in an effort to overcome such obstacles.

In addition to the earlier discussion of the problems involved in obtaining a management services engagement, it should be assured that the client's entire staff understand that the management desires this service, and believes that real benefits will result. It is very easy for personnel to get the idea that the "outsider" is simply there to spy on

them. The best weapon against this, and many other human relations problems which will be encountered, is to be certain that the client's staff understand just what problem is under study and how it is being approached. In many cases, a meeting at which the CPA outlines just what his work will involve will accomplish this informative function. In any event, it should be stressed that if the engagement is to progress smoothly and be mutually profitable to the CPA and management, a clear preliminary understanding of what will be involved in the study is a necessity.

With management aware of what problems the accountant has under review, the possibility of their gaining the impression that the engagement is being inordinately prolonged is minimized. This is important in service to small businessmen who may be more inclined to this prejudice than the management of a larger organization. In addition, management will be considering the various ramifications of the problem, while the accountant is at work. This process will facilitate their subsequent cooperation in implementing the recommendations.

During the preliminary planning and discussion, the CPA may encounter a tendency on the part of management to restrict his area of inquiry. This is natural since the client is sure he knows more about his own operations than the outsider can possibly learn in the time available to

him. In restricting the accountant's activities to what he believes are the sources of the company's difficulties, the client actually, although perhaps unconsciously, assumes responsibility for the diagnosis. Yet this function of diagnosis is one for which the competent CPA is particularly qualified because of his objectivity, open-mindedness, impartiality, and breadth of experience. In addition, the ultimate success of the engagement depends upon the freedom to study the entire organization in order to isolate for further study those variables which are the source of difficulty. Therefore, the CPA should insist on maintaining the diagnostic prerogative, but certainly not at the expense of appearing to regard himself as being endowed with omnipotence.

As he carries out the investigation, the accountant will often need to make use of the client's personnel and records. The extent to which the time and effort involved in collecting data can be thus reduced will depend upon several factors:⁵

1. The kind of problem. A budgeting assignment will involve extensive use of both records and personnel, while any problem such as the evaluation of alternatives in an investment study, which

⁵Joel Dean, The Management Counsel Profession, (Bloomington: Indiana University Press, 1940), p. 61.

requires a high degree of subjective judgment, must be performed almost exclusively by the CPA.

2. The purpose of the investigation. The objective of the study and the position of the consultant's principal may be such that cooperation cannot be expected.
3. The personality of the client. The client may hold the opinion that the CPA is being paid for the service; therefore he should not interrupt the daily routine.
4. The extent to which the work may be done on the client's premises. If a large part of the work can be done on the client's premises, then it should be understood that the engagement will be less expensive if his personnel assist in parts of the engagement such as some of the routine clerical work.

The CPA should understand that to simply recommend a new system or any particular change in procedure, is of only limited service to management. He can ensure lasting benefit by providing the client's personnel with an insight into the problems with which they must cope. The practice of providing a clear presentation of what is to be done before actual work is started has already been introduced. The "education" process should continue by keeping the client and his personnel apprised of the progress attained as the

study continues, and discussing tentative conclusions with them. To accomplish this laudable objective, it is necessary that the work proceed informally and on a personal basis that transcends organization charts, if they exist. Obviously, these recommendations represent ideals, which in any particular case may not even be approached. In any event, they are desirable ends and should therefore be at least suggestive of the best procedures.

Presenting the recommendations. The effectiveness with which the CPA's recommendations are presented determines to a great extent the benefits to be derived from the engagement. The accountant's contribution depends primarily upon the extent to which action is taken on the basis of his study.

Two methods of presentation are available--oral and written report. On the one hand, it is common practice to write a report covering the problems studied, the methods followed, the conclusions and the recommendations made.⁶ At the other extreme, no written report is submitted at all. The investigation is carried out informally and the recommendations are initiated solely through oral discussions with management.

The written report has definite advantages. (1) It

⁶Ibid., p. 62.

tneds to enhance the quality of the investigation by virtue of the incentive inherent in the knowledge that both methods and recommendations are to be permanently recorded. (2) In describing the methods of investigation and stating the reasons for the conclusion, it materially assists the client's organization in thinking through the problem.

(3) It materially reduces the hazard of misunderstanding ever present in an oral report. A written report is rather conclusive and sufficient unto itself. Therefore, it would tend to reduce the possibility of immediate follow-up. Such a report will probably be submitted at the end of the engagement and, unless it is immediately reviewed by both parties, it may be sometime until it is even read.

It is recommended that the presentation of recommendations to management be accomplished by a combination of an oral and written report. Oral suggestions are neither so final nor irrevocable as the written variety. Therefore, in matters of extreme sensitivity, the oral accompaniment to a written presentation must be emphasized. The question is not one of choice but of relative emphasis as dictated by the personality and ability of the manager, and the character of the problem and recommendations. It would seem to be a safe generalization that, considering the interpretive ability of many small businessmen, the oral report should receive greater emphasis, but not to the exclusion of the vital written analysis.

It is self-evident that any such written presentation should be prepared in the most understandable manner possible without sacrificing quality of content. It is imperative that the report should never be just a vehicle designed to enhance the technical reputation of the accountant through highly involved analyses which are beyond the understanding of the recipient. Rather, the report must be completely oriented toward facilitation of understanding by management, as well as the provision of new information.

Follow-up. Beneficial effects of the accountant's recommendations to management will be largely lost if he simply "reports and runs." A certain amount of follow-up is an integral part of every management services engagement.

Putting the accountant's recommendations into effect is the crucial phase of an engagement. In almost any type of service which the accountant can render to management, he cannot determine the degree of success to be enjoyed by his work until some period of time has elapsed after submission of the recommendations. Certainly, there are a few services, such as advice on whether to buy or sell a particular asset, in which follow-up is of very limited use simply because the decision is irrevocable. However, in the majority of cases, as already noted, the reverse is true. For instance, the success of a newly installed budget or accounting system must await the test of time.

The intensity of subsequent review necessary in an

individual case will depend upon the character of the recommendations made. If sweeping changes were recommended and adopted, then the review will be rather intensive and of a continuing nature. The amount of time which may be permitted to elapse before the review takes place is another matter to be determined by the character of the recommendations. Again, in a case involving anything so important as a budget or systems installation, it would be inadvisable to wait too long before undertaking a review of results. Very often, if difficulties are going to materialize, they will do so relatively early, perhaps as a result of an inadequate understanding by the client, of the tools placed at his disposal. It is extremely important to discover these difficulties early and correct them before they become established procedure.

At this point it will appear to many CPAs that discussion of human relations problems, education of the client's personnel, as well as a change in his own point of view or perspective, represent an over-elaboration of a few new services to management. This is most emphatically not the case. These considerations are just as important to the technique of management service as the independence of mind is to an audit engagement. By the same token, it would be most unfortunate if the tremendous opportunity to perform valuable service to small businessmen were lost through hesitancy to grapple with these intangibles.

CHAPTER VI

BUDGETING FOR SMALL BUSINESS

This and subsequent sections shall be devoted to the specific problem areas in which the CPA may render useful management services. The approach used is designed to accomplish a general orientation of the accountant to service in this area. Because of the extreme complexity and great length of an exhaustive study of each of the management functions in which an accountant may render service, no more than this effort at a general orientation is practical.

With regard to the choice of management functions in which an accountant may be of service, it should be noted that circumstances surrounding the entry of the accounting profession into such service dictate extreme caution. It is extremely important to the profession that early efforts in the field of management services be successful. Therefore it is recommended that these early efforts be restricted to treatment of those functions for which the accountant is most highly qualified, by virtue of attainments in currently recognized accounting endeavors. Specifically, such attainments involve success in the uniform CPA examination, coupled with a few years of responsible practice in public accounting. Certainly management services, especially in the initial stages of such work, are

not for those of minimal experience in public accounting.

Thus, the study of the specific management areas in which a Certified Public Accountant may render valuable advisory services is undertaken in cognizance of the admonition concerning competence. Therefore, the budgeting tool has been chosen as a beginning; a beginning both in the sense that it is of sufficient importance to merit first place in any enumeration of management services, and that it is a desirable way to inaugurate this type of service to a particular client.

By virtue of the fact that the budgeting process involves use of historical data traditionally prepared by accountants, the profession is immediately at an advantage over other outside consultants who might presume to render this service. In addition, the relatively simple budgetary systems best suited to small businesses closely parallel the accounting function. That is, very often the budget is simply a detailed set of financial statements, with supporting schedules, prepared on the basis of plans and estimates for the future rather than exclusively historical data. Furthermore, the fact that the CPA is identified with figures in the mind of the typical small businessman, will make it easier to convince them that this is a legitimate extension of the traditional public accounting service.

In most cases, the benefits from a carefully designed and installed budget are soon forthcoming. Moreover, these

benefits are the type most sought after by business management; specifically, the reduction of costs with accompanying increases in profits. Thus the CPA will be quickly identified with the production of profits, and the word-of-mouth advertising on which the practitioner must rely to enhance his reputation will be augmented. Often, as a result of his effective application of the budget tools, the management of a firm will be eager to have the CPA serve in other areas of the management function. As a rather practical sidelight, a successful performance in budgeting technique will gain the practitioner a degree of prestige. As a result, the firm will allow him extra time in which to perfect other management services for which he is not so highly qualified.

Without the use of a budget, the planning and control functions of management must be conducted on a trial and error basis. This is a highly hazardous and expensive process. Small businessmen rarely have the luck to remain in business long enough to perfect this intuitive type of control. Decisions made at the last minute are unduly influenced by the most recent conversation with a customer or supplier, while advance planning increases the objectivity with which any particular problem is approached.

This tendency is exemplified by the following situation. A new customer, or perhaps two, may appear with sizeable orders on the day when the manager is to

order merchandise. If he has not planned in advance and considered the general economic health, he will probably be urged to over-optimism. As a result he might incur obligations for inventory which were unfortunate in terms of his sales prospects. Obviously the probability of an increase in sales was not changed by the chance occurrence on the day he ordered.

Finally, the use of the budgeting function as an introduction to management advisory services firmly lodges the Certified Public Accountant in the highly touted controllership approach to this sort of service. The contention is that the professional accountant is best suited to, and has a responsibility to fill this important gap in the management of most small firms. This approach to the problems of small business augurs well for both the public accounting profession and the business community.

A difficult selling job. Although the term "selling" is often repugnant to the highly ethical CPA when applied to his practice, there remains the rather difficult job of convincing many small businessmen in need of budgeting that it is desirable. Because of ethical restrictions on the practice of soliciting business, the CPA must usually depend on a prior association with a business firm for the opportunity to open management service. This fact is not altogether detrimental to efforts to inaugurate budgetary services. Because of various misconceptions concerning

the budgeting technique, an intimate association with a business can prove to be a real asset in convincing management that the practice is desirable. Through his auditing and tax work the accountant will very often have gained the respect of management, which will make them more receptive to his proposals regarding a formalized system of planning and control.

To the extent that a small business manager has given any thought to the budgeting technique, he usually regards it as a big business luxury with little or no application to his own operation. In addition, his usual aversion to "paperwork" encompasses the concept of detailed planning. Often the small entrepreneur takes pride in the feeling that he is capable of running his operation "from his head." Obviously, it will be necessary to remove these misconceptions before management will provide the endorsement which is necessary to effective operation of a budget.

Because of constant reference to the characteristics of government budgets in the communications media, a relatively naive manager may regard the technique as of a restrictive nature. Recent experience with the federal budget demonstrates the fallacy in this concept in spite of any intentions prevailing to the contrary. Budgets of any kind, but particularly those of a business, must be sufficiently flexible to allow for adjustment of the

budgeted amounts to the actual conditions experienced in the period of interest. In point of fact, a carefully conceived budget works to release the day to day operations of a business from the restrictions imposed by circumstances which could have been avoided if a measure of planning had been attempted. Most businessmen who don't utilize the technique can easily recall the unexpected demise of an old piece of equipment which caused an urgent scramble for funds to replace it. Such an occurrence was unexpected only because little thought was given to when replacement would be necessary and how it might be effected. Those responsible for funds upon which the businessman might seek to draw at such a time, would conceivably be reluctant to advance funds to a management that had not planned for such a contingency. The CPA would do well to effectively point out to the client that the planning involved in budgeting would have ameliorated the difficulties involved, either by obviating the need for reliance on outside sources of funds or have made acquisition of such funds easier. The manager could have approached the bank with his request well in advance of the actual need, thereby materially increasing his chance of being well received.

The control aspects of the budgeting function are restrictive in the sense that, by maintaining the profit objective paramount, certain expenditures will be reduced or eliminated. Clearly this is not an undersirable

restriction, if one at all. It is rather a reliable method of stimulating rather than inhibiting management decision.

A busy manager will often feel that he has too much to do already, without the additional work of budgeting. He must be made to realize that proper operation of the budget will reduce the number of routine decisions he must make daily. A budget is the instrument of effective delegation of authority and responsibility. It is effective in that a full measure of control can still be retained through management by exception, while the manager's work load is reduced making his talents available for the more appropriate functions of administration.

Perhaps the most difficult management preconception concerning budgeting to deal with, is the impatience with the "guesswork" involved. Traditionally, the small business management group lives in high regard of absolutes, and with a desire for a trite answer to every knotty problem. Here the accountant faces his biggest task in educating the small business manager. Paperwork, including forecasting activities, cost comparison and control, as well as the collection and processing of ordinary accounting information, must be regarded as much more than an unpleasant necessity to be ignored whenever possible. This will be a protracted process requiring real proof that the formalized system has advantages over the intuitive type of control, and is therefore worth the extra work and expense. Terms currently

in vogue such as "scientific management" and "figure consciousness" describe the inquisitive, analytic type of approach that is requisite to the highly efficient operation of any business.

Doubt is often expressed as to whether a particular business is of sufficient size to warrant the use of budgets. According to the American Institute of Certified Public Accountants, "any business, from a one-man newstand to General Motors is better off with a budget than without one."¹ As published by the institute, this statement is rather misleading. If budgeting is thought of as a formal plan, recorded in some detail, then certainly not every business is better off with one. Many, many business organizations are too small, and their operations are too simple to warrant the devotion of the amount of time necessary to prepare such a budget. However, if budgeting is thought of as planning and control committed to writing in detail in some cases and not in others, then certainly every business has need of the tool.

It is extremely important that the CPA, who presumes to advise the management of a small business that budgeting is desirable, emphasize that budgeting is merely a tool.

¹ American Institute of Certified Public Accountants, Management Services by CPAs: Budgeting for Profit in Small Business, A Research Bulletin (New York: American Institute of Certified Public Accountants, 1959), p. 5.

A budget alone is not a panacea. It must be used aggressively for it is simply a device to guide the control of an enterprise. After the carefully laid plans have been formalized into a budget, then there must be constant comparison between the budgeted and the actual, coupled with decisive action, as indicated by the reasons for deviations from the plans.

What it is and what it does. It was suggested at the end of the preceding section that budgeting is a tool, a means to an end. A proper perspective concerning this function is impossible without careful consideration of just what "end" must be kept in mind. The fundamental objectives of an enterprise management, in any given accounting period, must be: (1) to earn a satisfactory profit, (2) to maintain a sound financial position, and (3) while realizing the two previous objectives, to do nothing in the current year which will be detrimental to the long-run success of the enterprise.

The term budgeting, as any word that is subjected to constant use, means many different things to different people. Often it is thought of only in terms of expense control. This would be something of the appropriation type budget, which places a maximum on the amount of money that can be expended on a given activity. A second type of expense control budget is the so-called flexible expense budget.

A more accurate definition of a budget now in vogue encompasses elements of the two types of expense control budgets, but adds a new dimension. Mr. Robert W. Lewis of the General Electric Corporation describes this broad type of budget as:

the expression, in financial and other appropriate terms, of an integrated plan of operation for a specified period of time, usually one year. It includes, therefore not only expense budgets but such budgets as sales production, material, labor, and plant and equipment. More importantly, the interaction of all the individual programs is reflected in a statement of profit or loss, a balance sheet, and a statement of cash flow for the business.²

Thus a budget is a means of coordinating all the major activities of a business enterprise, and directing their accomplishment toward a thoughtfully conceived goal. This goal, and the effort directed toward its accomplishment, must be decided upon by the entire management group, acting in full cognizance of the strengths and weaknesses of the particular firm. Their decision must be reconciled with such externally derived data as may be pertinent. The systematic integration of external and internal information mentioned here is possible on a full time basis for only the largest and best-staffed firms. However, it is just as essential for the small operator. Naturally his use of such data will be on a more informal basis. However, some

²Robert W. Lewis, "An Industry View of Budgeting," The Journal of Accountancy, (December, 1959), p. 30.

measures of potential demand, and probably future cost structures is essential to useful budgeting.

As stated earlier, the budgeting function has two principal phases--planning and control. The planning phase facilitates the coordination of the activities of the various functions. For instance, it will put production on notice of what and how much marketing is going to sell. The budget provides the vehicle for the communication between responsible employees, which is so important to coordination of their activities. Probably the most important aspect of the planning phase of budgeting is that management is forced to subject their instinctive or intuitive intentions to objective tests. Very often, after engaging in intensive advance planning, management will be shocked at the inadequacy of prior knowledge of what is necessary if the business is to attain its goals.

Just as important as planning is the control phase of the budgeting function. Control is the action necessary to assure that plans and objectives are being achieved. The objectives of control have been outlined as "assurance of correct performance as specified by a plan; a well-coordinated action; and a minimum of losses due to interferences with the proper execution of the plan."³ Thus,

³Ralph C. Davis, The Fundamentals of Top Management, (New York: Harper & Brothers, 1951), p. 630.

control in budgeting may be thought of as a systematized effort aimed at keeping management informed of conformance, or lack of conformance, to predetermined plans, objectives, and policies. Budgeting does not in itself control; that is still a line responsibility of management. However, budgeting provides the yardstick which is necessary to the measurement process implied in control.

There is often confusion among business managements concerning this measurement process. It is something of a tradition to compare current performance with that of the past. When a budget is in operation this is a serious error. Control cannot be effected by mere comparisons with historical data. What happened in the past is not an appropriate standard of performance from which evaluations of present operations are to be drawn. Proper evaluation of performance can only be measured against a plan which includes provision for all the vagaries of present circumstances, not those of the past. Thus it is obvious that the important control phase of budgeting is only as effective as the planning phase is accurate. If the plans which make up the standard of performance fail to take cognizance of important influences on the business, then the quality of control will be markedly reduced.

There are many schools of thought concerning what sort of plans management should incorporate into a budget. At opposite extremes are those who advocate conservative

planning (therefore that which is likely to produce easily achieved goals), and those who subscribe to "reach" budgeting, which incorporates difficult goals unlikely of achievement. The type of budget with the least possible chance of unpleasant repercussions is the one which bases its plans upon what is most likely to occur during the budget period. If the very best judgment of management as to what will happen is the basis for budget planning, then those responsible for the attainment of each section of the prognostication will view it much more favorably, and thus improve the chance for success. This recommendation is not meant to exclude any incentive or "reach." Clearly, budgeting for inefficiency would be worse than none at all. The determination of the amount of "reach" to include is crucial. It requires a rigorous appraisal of what kind of job has been done in the past in achieving objectives.

In concluding the description of budgeting, a word of caution is in order. When at any time the budget objectives are reached, management should be sure to conduct a careful analysis of results before distributing rewards, monetary or verbal. The mere fact that performance has measured up to plan is not conclusive evidence of the quality of the managerial job. There may have been changes in the actual environment during the period which might have produced substantially greater gains than were made. Thus, in spite of the appearance of success, operations may have

been quite substandard when considered in the light of the potential. Management would be deluding itself if weaknesses in planning, which were revealed by subsequent events, were glossed over in favor of self-congratulation on achievement of objectives.

How much budgeting? It is something of a truism that businesses of varying size and character require the budgeting function in differing degrees. It was suggested earlier that certain extremely small businesses require no formalized budgeting whatever. As in any generality, there is danger in this statement. Some single proprietorships with no employees can make excellent use of the technique, while others cannot.

Below the point in enterprise size where there are no longer specific responsibility centers under different individuals, the need for budgeting depends upon the demand situation which the firm faces. A firm operating under a highly stable demand will find it uneconomical to engage in any budgeting on a formalized bases. This is not to say that planning and control are not to take place, but simply that a full blown budgetary system is superfluous. This applies particularly to sales and operating budgets. To the extent that such a firm is contemplating borrowing funds or undertaking equipment purchase or replacement, a forecast of cash flow will be extremely useful. With sales enjoying a stable year-round behavior,

the purchasing function will be largely that of reordering similar quantities periodically. The most economical order size, although to many a budgeting problem, is a matter of cost reduction and control which will be investigated in a subsequent section of this paper.

All businesses, however small, which sell a stylized product or one subject to seasonal fluctuations in demand, are better off with a budget than without one. It is true that budgeting is more difficult where style, design, weather conditions, and other such fluid factors influence in varying degrees both sales and production costs. It is equally true that especially in such cases, prudent management and successful operation require constant reappraisal of these changing elements, and their effect on probable revenue and costs. Thus it appears that among the many variables which determine the character and degree of budgeting necessary, size is not as important as is often thought. Between the two extremes, a fully integrated systemized budget system and what is actually only partial budgeting, there is an immense variety of applications of the budget technique depending upon many other operating characteristics in addition to mere size.

Especially at the outset, budgets and the budgetary system should be kept as simple as possible, and as free of detail as effective operation will permit. It has been suggested that the majority of small businessmen abhor

complex, detailed procedures with which to effect the financial planning and control of their operations. Since each budget system must be "tailor-made" to the particular business, the CPA should carefully assess the needs of the enterprise and then install what to him is the very minimum. If management has the opportunity to observe the effectiveness of a rudimentary budget system, that system will rapidly improve as a result of the enthusiasm thus generated. On the other hand, if the accountant waxes overly enthusiastic and tries to effect too many changes, in spite of the fact that they are beneficial, the management will be quickly "scared-off." If this is the result, rather serious harm to both the CPA and the business will result. The general feeling of small businessmen that many of these scientific management techniques are merely embellishments will be reinforced, and the accounting profession will suffer a loss of prestige.

Prerequisites to effective budgeting. From the point of view of the professional accounting practitioner, it is of the utmost importance that he should have an intimate knowledge of the particular business enterprise before he seeks to advise on the intricacies of budgeting. The chief advantage of budgeting is that it necessitates a detailed examination of performance, both machine and human performance. To approach the installation of a budget system without careful examination of the peculiarities of

the firm, is to invite failure.

A list of prerequisites to effective budget performance follows:⁴

1. There must be an adequate system of collecting and recording financial and operating data.
2. Where the operation is of sufficient size to necessitate division of responsibility, both responsibility and commensurate authority must be delegated.
3. The chart of accounts must be such as to facilitate the proper allocation of charges to each responsibility center.
4. Cost accounting data should be available or readily attainable.
5. The entire program must have the active and wholehearted support of all those to be held responsible for a given segment of the endeavor.

Some of these have appeared earlier in another context. However, each is of sufficient importance to warrant repetition.

Naturally what will be considered an adequate system of collecting and recording financial and operating data, as well as what data should be recorded, will vary among

⁴Glen A. Welsch, Budgeting: Profit-Planning and Control, (Englewood Cliffs, New Jersey: Prentice-Hall, 1957), p. 17.

small businesses. Certainly there will be minimum requirements no matter what type of business is involved. These will include: (1) total days or at least weeks sales in dollar amounts by product, (2) information on materials used, including amount used (for a manufacturing firm), as well as date, amount and cost of purchases, (3) employment data including number of personnel, the activity in which each is engaged, and their pay scales, (4) a record of all important expenditures which contribute to the routine operations of the enterprise which are not, however, directly assignable to any particular product or the production process in general. To any accountant without wide experience in service to small business, inclusion of the foregoing list would appear superfluous in that the items therein are extremely elementary, and it is hard to visualize any business without these records and more. However, any CPA whose practice includes service to a variety of small businesses will very likely not share the incredulity of his more sophisticated colleague. In this connection an article in the "Harvard Business Review" refers to an interesting survey conducted by the United States Department of Commerce.⁵ The results of this 1946 survey of records kept by small businessmen are as follows:

⁵Paul F. Lawler, "A Note on Control in Small Businesses," Harvard Business Review, (September, 1947), p. 523.

Per Cent of Companies
Asked

No business records at all	28
Files of source media only	15
Some form of single entry	49
Double entry records	<u>8</u>
	<u>100</u>

In all probability the situation is not this serious now, especially if a CPA has had any association whatsoever with the business.

The records described above must have been maintained over a length of time, which will enable the accountant to gauge the effect of changes in the operating environment. This is simply to say that a sufficient basis of comparison must be available in order to ensure the necessary accuracy of planning.

Certainly a great many business enterprises are too small to necessitate any division of responsibility. In these businesses, responsibility for the budget and its success will be completely in the hands of the top management, which in these cases will be the only management. Other businesses will be of a size which makes it impossible for one man to personally oversee all the important phases of the operation. Before a budgetary system will function properly, the delegation of responsibility must become an actuality, not just something to which the proprietor pays lip service. Moreover, if an individual is given the

responsibility for efficient performance of a particular phase of operations, he must have authority commensurate with his responsibility. Without the authority to carry out his recommendations, the individual will not welcome the installation of a budget designed in part to measure his performance.

Although the existence of centers of responsibility in a business above a certain size is of vital importance to the success of a budget, the CPA should be very careful to avoid recommending sweeping changes in organization. This sort of action would interfere with the jealously guarded prerogatives of management, and would surely doom the budget as well as the CPA's association with the business. While certain organizational changes are necessary, the idea must be that of management. Thus the accountant remains an advisor only, simply pointing out that perhaps if this particular change was made, such and such a beneficial effect would result.

Often a relatively easy way to accomplish organizational changes is to introduce management to the technique of preparing organization charts. This will be a new technique to most small businessmen. Usually it is thought of as highly complex and not applicable to a relatively small firm. If approached properly, it is a relatively easy technique to master, and well worth the time which top management must devote to it.

The Small Business Administration recommends⁶ that in approaching this job, the manager first chart his impression of the structural relationships existing in the firm. This will produce a highly idealized chart which will in most cases not be very close to the real situation. It will, however, be a valuable starting point if only to stimulate management's thinking on the problem.

To bring this chart into agreement with real-life conditions, management should list the names of all employees, followed by their titles and duties. The next step is to group, under their immediate supervisors, the employees having the lowest common grade. This gives the two bottom lines of the organization chart. On the line above, post the names of the individuals who supervise more than one group. This approach is followed successively up to the top. At this stage, many managements will be sufficiently exasperated by borderline cases, and cases of one individual reporting to more than one supervisor, to welcome the CPA's assistance. The CPA should then establish centers of responsibility on a functional basis according to the needs of the particular firm. If the size of the firm and the complexity of its operation warrant, a system of reports should be installed. This system should be kept

⁶Erich M. Hauer, Rating Your Firm's Organization, Small Business Administration, Management Aids for Small Manufacturers, (Washington: Gov't. Printing Office, 1958).

as simple as possible with only essential information on material and labor use, as well as quantity of production, reported periodically.

The chart of accounts must facilitate the proper allocation of charges to these responsibility centers. Many accounts will be in existence which report an expense by type rather than function. Each such account must be replaced by others reporting the expense according to the functional cost centers which have been set up.

A few of the changes which must be effected before installation of a budget system have been reviewed. The point is that the CPA must not allow inefficiencies arising out of unsatisfactory accounting, operations, or personnel to be frozen into budget standards.

Preparation of a budget system. Only a few generalizations concerning the actual budgeting procedure applicable to small business are possible. It has already been established that the intensity or degree of budgeting desirable for a particular firm will vary with the size, organizational pattern, demand, and complexity of operations. For any particular firm the degree of budgeting will vary between a complete system, best suited for a firm of moderate to large size, and what has been labeled "partial budgeting."

A comprehensive budgetary system would include (1) a sales budget or forecast, (2) production and inventory budgets, (3) an operating (income) budget, (4) a capital

budget, (5) a financial budget,⁷ and sometimes various supporting schedules which are not particularly necessary in the moderate-sized business.

What products are going to be sold, how much of each one, and when must they be delivered? Answers to these questions will form the sales budget. Since all other aspects of the firm's operations depend to some extent upon the forecast of sales, the sales budget (in addition to its immediate use in administering sales activities), forms the cornerstone of the planning and control system. It will be helpful if the expected volume is expressed in units as well as in dollars. Also, in order to provide for seasonal fluctuations, it is usually worthwhile to detail these figures monthly for a full accounting period.

This is the point at which many budgetary programs are abandoned. Innumerable reasons can be given as to why the sales forecast cannot be made, such as unavailable facts, unforeseen events, and unpredictable conditions. The only answer is that it must be done. At the same time, it must be expected that variances will develop from the original budgeted figures. Management must simply make provision for such deviations when acting on information obtained from the budget.

⁷Thomas M. Hill and Myron J. Gordon, Accounting: A Management Approach, (Homewood, Illinois: Richard D. Irwin, Inc., 1959), p. 459.

The first step in developing a sales forecast is to break down internal sales records by months, customers, territories, or by any other characteristics important to the particular business. In developing figures for the first time, it would seem advisable to go back as far as practicable. About 10 to 15 years is sometimes recommended as a safe period, since it will include several business fluctuations in the national economy.

Reliance exclusively upon what the business has done in the past is somewhat dangerous, especially if the product is a so-called luxury item, and therefore highly sensitive to the vagaries of the marketplace. The best procedure is to relate sales of the industry, and the share of industry sales usually enjoyed by the firm, to some outside statistics. In the choice of such external data the following points are important: (1) the time series should have been published at least as long as the period for which the company has records, (2) they should be kept up to date and be readily available, (3) they should be in a usable form, that is, no further work on them should be necessary prior to use, and (4) they should be collected by a reliable, nonbiased source. The statistical indicators prepared by the National Bureau of Economic Research, and published in the financial press, pass each of the above tests. Specifically, such leading indicators as the industrial common stock price index, the dollar value

of new orders for durable goods, and the index of wholesale prices of 28 basic commodities, should be particularly useful for sales forecasting purposes. Careful use of internal data, coupled with these indicators of probable future business activity, should produce a sales forecast of excellent reliability.

The production (or purchasing, with respect to a mercantile concern) and inventory budget is important to cost control, and to ensure an adequate supply of product to meet expected sales. Operations must be carried on at a level which utilizes the equipment efficiently, keeps the labor force intact without excessive turnover, and provides an adequate, yet not expensive, inventory from which shipments can be made according to desired delivery dates.

Preparation of this budget begins with establishment of the inventory plan. For any level of sales there is an inventory level at the start of the monthly period which will minimize the sum of purchasing and carrying costs. The determination of this inventory involves the establishment of minimum order points, and the optimum order size which will be considered in a subsequent section under cost control.

One of the most common types of budgets is the income and expense, often called operating budget. In it expenses are divided into fixed and variable, and combined with the forecast of sales in an effort to determine what

the net profit should be for a particular period. In its simplest form, this budget is simply an income statement prepared with estimated rather than historical data. At the other extreme is a budget for each functional expense classification. Within each classification are flexible budgets.

For the majority of small business firms, the very simple projected income statement type of budget seems advisable, at least as a start. As management becomes familiar with the use of the tool, the more sophisticated approaches to expense budgeting may be introduced.

The concept of controllable and noncontrollable costs is extremely useful in budgeting for performance. This idea should be introduced to the management group as early as possible. In fact, this may be a useful selling point. If it is explained to the supervisor in charge of a particular responsibility center that the performance of his section will be judged solely upon the behavior of those costs which are under his direct control, then surely he will be more receptive to the installation of the budget.

The capital budget considers such items as planned plant extensions, extraordinary repairs that are to be capitalized, building programs, machinery acquisitions, and other permanent capital additions. Although the capital budget, like any other, is prepared for the immediate year, it must take into account: (1) the firm's

long-range objectives, (2) the long-run financial strength of the firm, and (3) the alternative uses of the funds. Indeed, many large businesses have long-range capital budgets to ensure that these vital considerations are given their due attention. The application of this sort of a long-range budget to the smaller firm may be very useful in some cases, but as a general rule, it seems that since the smaller firm does not have need for highly expensive equipment, this budget would be of very limited use.

The annual capital budget is used in conjunction with the cash or financial budget to ensure that funds to provide for capital acquisitions will be forthcoming during the year. The CPA can perform an important service by seeing to it that the limited funds available are judiciously managed. He can find the best source of new funds. He can acquaint the client with objective methods of determining the advisability of capital outlay, such as the return on investment.

In terms of the consequences resulting from operation without a cash budget, it is the most important single scientific management tool. The lack of liquid assets with which to meet currently maturing liabilities is reported to be the largest single immediate cause of business failure.⁸

⁸"Record Business Birth Rate--Record Failure Rate," Fortune, LIV, (October, 1956), p. 50.

As suggested earlier, a detailed projection of cash flow will reduce the need for funds drawn from outside sources, as well as reduce the difficulty in obtaining such funds when it is necessary to do so.

The preparation of a cash budget must include provision for the replacement or production cycle of merchandise, together with the inventory policy. In addition, any seasonal fluctuations to which business is subject must be considered.

As far as the mechanics of preparation are concerned, it is often the practice to prepare a general approximation of cash flow for the coming year. Then the forecast is prepared in detail for the coming three months, with each month dropped at its close, and the next one added. In general, the sources of information utilized are: (1) figures relating to routine daily operations, (2) any non-operating transactions which involve the use of cash, and (3) transactions involving changes in the capital accounts.

Preparation of a useful cash budget requires records, good business judgment, and experience. If carefully prepared and used, it can minimize the need for short-term borrowing in order to meet current financial obligations. Constant comparison of actual cash receipts and disbursements with the cash forecast, in order to adjust the forecast to reflect anticipated requirements for the immediate and long-term future, represents intelligent use of this

valuable tool. Certainly it is too late to plan a financial program when the cash requirement has arisen.

A useful cash position report to be prepared daily and submitted to management seems desirable in view of the importance of maintaining liquidity. Such a report, which appears to be particularly applicable to the small or moderate-sized business due to ease of preparation, has been suggested by R. S. Wasley in the NACA Bulletin.⁹ The information revealed by this report is suggested by the following column headings:

Status of Business Report

<u>Date</u>	<u>Sales</u>	<u>Sales to Date In This Budget Period</u>	<u>Receivables 30 Days Old</u>
		<u>Receivables, Same Day Last Year</u>	<u>Cash Balance</u>

Naturally the underlying record system must be designed so that this information can be taken off quickly and easily.

The five budgets just studied make up a comprehensive budgeting system for a medium-sized business. For most really small businesses, this same program would represent too great an emphasis upon the budget tool. Any business should not engage in budgeting, or any other scientific management procedure, beyond the point where further

⁹Robert S. Wasley, "Cash Position Budgeting: Bulwark of Small Business," NACA Bulletin, (February, 1957), p. 787.

application of the technique would not produce improvements in operating efficiency, and therefore no greater return on net worth. Acceptance of this criterion will obviously preclude application of a full budgetary system to many small businesses. This is not to say that these businesses cannot make use of some planning and control devices.

The problem for management of a business too small to make use of an integrated budgeting system, is to decide which parts of the technique can and should be adapted to their use. Naturally, as has been stressed before, the operating and organizational characteristics of a particular firm will largely determine its needs in this respect. Therefore, as the following attempt to generalize upon "partial budgeting"¹⁰ unfolds, it should be kept in mind that some of the devices described will not find a useful application in many businesses, while others not mentioned may be very useful. The reader is reminded that this and subsequent sections represent an attempt at a general orientation to management service, not a preparation designed to enjoy either universal application or to include all the problems a practitioner may encounter.

Certainly, one portion of the budget program which no

¹⁰The term partial budgeting and the concept are used by Norman J. Elliot in the following article: Norman J. Elliot, "Partial Budgetary Control Applications in Small Business," New York Certified Public Accountant, (June, 1955), pp. 337-42.

business can safely do without is the projection of cash flow. Because of the wide variety of data that must support a cash budget, it will appear to be something of an anomaly to advocate its use, while contending that detail must be minimized for the sake of economy. The only defense is to reiterate the necessity of the cash budget. At the same time, it should be noted that businesses of this size are most often found in those areas of the economic community which are the least subject to wide fluctuations in revenues and costs. Specifically, these firms are found in retail trade and the services. Moreover, they represent that portion of these relatively stable industries, which maintain a reasonably fixed clientele. Therefore, once the job of estimating sales and expenses is done, for the first time, in the manner described, it will be relatively easy thereafter.

Other partial budgeting devices involve the use of the key control technique. Particularly troublesome parts of the operation are chosen, and standards of performance are set. Periodically thereafter, these standards are compared with the actual experience. Very often it is desirable to express these key controls as indices, with an activity factor, such as man or machine hours used, as one of the variables entering into determination of the index. The other variable will be the dollar value of the key expense item that is in need of close supervision.

In some cases this index may measure material used per hour of machine operation, material used per unit of product (the calculation of equivalent units in process complicates the latter relationship), or material used per man hour of direct labor. Continuing with emphasis on the small manufacturing operation, another useful index would measure the productivity of labor. This might be accomplished by comparison of direct labor hours and finished product, or direct labor hours and material placed in production less scrap.

Each of these relationships provides a spot check of a particularly troublesome area of responsibility. Just as is the case with any standard, these indices must undergo periodic review to see that important relationships have not changed in a matter which would tend to vitiate their original utility.

In other cases, partial budgeting will involve a more sophisticated approach in the form of preparation of specific budgets of controllable costs. Sometimes general overhead will begin an unexplained rise. A specific budget, therefore a portion of the general operating budget, may be useful in such a situation. Simply because partial budgeting rather than a full system is employed, the advantages to be derived from the planning and careful investigation necessary, are not lost.

Thus the CPA has the fully integrated budgeting

system, the partial budgeting system, and a wide variety of intermediate types to apply to the problems of small business. After preparation of the initial budget system and its installation, it would be uneconomical for the outside expert to continue to perform many of the day to day duties necessary. In fact, the professional accountant would be neglecting his responsibility if he failed to educate the client's personnel in operation of the budget. He must teach them to use the information supplied by comparisons of budgeted with actual costs, as well as instill the idea of exerting a constant effort to improve the budgeting function. The CPA's long-term relationship to the firm's budget program will be something like a part-time budget director or coordinator, who will be periodically called upon to solve a particularly difficult problem.

Limitations of budgeting. The list of advantages in budgeting is impressive, but it should not be assumed that it is a foolproof tool. Its limitations are very important, and it is imperative that those who consider using budgeting control be fully aware of them. Often in spite of frequent assurances of their awareness of the advantages of budgeting, the management team will fail to give the active support necessary. Indeed a further serious disadvantage can result from a lack of information on the limitations involved, in that too heavy a reliance

may be placed upon the technique.

Aside from limitations built into the budget through faulty preparation, the CPA should take special note of the following: (1) the budget plan is based on estimates and therefore is never infallible in that it is almost impossible to provide for all the contingencies which may arise, (2) the business situation to which the tool must apply is dynamic and everchanging, while the budget remains relatively static for the accounting period, and finally (3) the budget does not take the place of management and administration; it only makes it easier.

Discussion of the budgeting function has received a lion's share of the space allotted here to a review of the specific management services. Justification for this decision lies in the fact that it is the budgeting technique, properly applied, that can do most to alleviate the problems of small business, and thereby enhance the professional prestige of the CPA. Budgeting, of course, is not a panacea, nor is it the only important management service. However, it is the best means of helping management help itself.

CHAPTER VII

FINANCIAL MANAGEMENT IN SMALL BUSINESS

Financial management involves the husbanding of existing financial resources in such a manner as to minimize the necessity of externally derived funds. In addition, it is the responsibility of financial management to determine when it becomes advisable to draw upon such external sources as are available, and in what amount. Finally, it includes the cultivation of these external sources of funds in such a manner that they will be available when needed.

The financial management function represents one of the most important "voids" existing in the management of many small businesses, which explains in part the hue and cry constantly heard that the existing capital markets are discriminatory toward small business. It is to be expected that an improvement in the quality of general management of the small firm would result in easier access to the capital markets. An important method of achieving improved general management was outlined in the last chapter. This chapter is concerned with those efforts of the CPA which may be directed toward improvement of financial management. It should be kept firmly in mind that any improvement in the general management function will reduce the difficulty of financial management.

The American Institute of Certified Public Accountants suggests¹ that CPAs desiring to aid in financial management assume the status of a public treasurer. To function as a public treasurer to small business managements, a CPA must know at least as much about methods and sources of financing as the private treasurer, and his knowledge must extend to the many sources available only to small business.

A treasurer must keep abreast of economic conditions, capital markets, and money availability. During periods of credit restraint lending agencies logically raise their standards to all sizes of borrowers. Since small businesses generally are not as credit worthy as large businesses, and since their credit worthiness tends to deteriorate more rapidly, the various credit restraints affect small businesses more adversely than large businesses. Therefore it is necessary that the "public treasurer" remain continually informed on the economic situation and the outlook for changes in the money market, particularly on a regional basis.

OBE survey of financing. Before beginning the consideration of the contribution a CPA may make to the

¹American Institute of Certified Public Accountants, Financing the Small Business, (Management Services by CPAs No. 3, New York: American Institute of Certified Public Accountants, 1959), p. 8.

financial management of a small business, it will be useful to examine the reliance of these businesses upon the financial markets and their success in acquiring the needed funds. The Office of Business Economics of the Department of Commerce in 1954 undertook a survey of small and intermediate-sized business financing and arrived at some rather significant conclusions.² Table III reveals that approximately one-half the businesses in the sample had to rely upon outside funds. The greater financial independence of established businesses probably reflects the better earnings records of these firms when compared with the newer enterprises. This supports the belief that small business prefers to finance itself out of earnings whenever possible. The survey notes that in the aggregate, established firms relied upon outside funds more often than the newer firms. This is probably a reflection of the fact that by far the preponderant share of the business population at any given time is made up of established firms. Thus it must be remembered that the data in Table III are merely a percentage distribution within the two groups, rather than a reflection of the aggregate demand for funds. Nevertheless, it is significant that if account is taken of those firms which reported a willingness to depend entirely on internal

²Laughlin F. McHugh and Jack N. Ciaccio, "External Financing of Small and Medium Size Business," Survey of Current Business, (October, 1955), p. 15.

TABLE III

OUTSIDE FUNDS WANTED AND OBTAINED

Per cent Distribution of Established and
Newer Firms in Survey

(Twelve Months Ended June 30, 1954)

	<u>Established Firms</u>	<u>Newer Firms</u>
Outside Funds Not Wanted	57	47
Outside Funds Wanted:		
All funds obtained	24	25
Some funds obtained	12	19
No funds obtained	<u>7</u>	<u>9</u>
	<u>100</u>	<u>100</u>

Source: U. S. Department of Commerce, Office of
Business Economics.

financing, roughly 80 per cent of the older firms and 70 per cent of the newer firms had the desired financing either from internal or external sources.

Loan demand was clearly the predominant form of financing desired by the firms in the survey, accounting for 93 per cent of total funds wanted. Of the funds actually obtained, 97 per cent took the form of loans, with the remaining 3 per cent being in equity form. Equity financing was, however, of considerably greater importance in the unfilled demand.

Although the equity share in total funds desired was not large for either established or newer firms, the newer group both sought and obtained a larger share of outside financing in this form.

No attempt was made in the survey to analyze in detail the significance of the unfilled demand, which amounted to about one-fourth of the total reported in the survey. However a few generalizations were made, two of which are:³

1. A portion of the unfilled demand was of a nature which could not and perhaps should not be met under existing institutional arrangements. A number of firms indicated for example, that while they wanted the money, they felt their then

³Ibid., p. 17.

existing circumstances warranted a refusal by the lender.

2. In the survey instructions, firms were asked to report unfilled demand only if they had a specific financing program in mind. Thus a significant portion of the unfilled demand was never brought to the attention of the lenders, as some of the reporting firms felt that there was "no use in trying."

This unreported, unfilled demand came mostly from the smaller firms surveyed. When this demand is added to the 50 per cent of the small firms which had financing programs which were not met in full, it is revealed that there is a substantial amount of unfilled demand for funds on the part of small firms. Thus, a CPA whose practice involves mostly small firms, will find ample opportunity to exercise the prerogatives of an "independent or public treasurer."

The size of loans wanted by the survey firms ranged from less than \$500 in a number of cases, to several million dollars in a few cases at the upper extreme. Table IV summarizes the medians of the loans wanted by small and medium size businesses in different industries. The medians rather than the arithmetic means are more significant since they avoid the undue influence which the very large loans may exert on the arithmetic mean. This table

TABLE IV

MEDIAN AMOUNT OF BORROWED FUNDS WANTED BY FIRMS
IN SURVEY: OBTAINED AND NOT OBTAINED

(Dollars)

	Median amount <u>obtained</u>	Median amount wanted but not <u>obtained</u>
All Firms	8,000	10,000
Established firms	8,600	10,000
Newer firms	4,500	10,000
Established Firms		
Construction	8,100	10,000
Manufacturing	15,000	20,000
Wholesale Trade	14,500	25,000
Retail Trade	4,000	10,000
New Firms		
Construction	5,000	10,000
Manufacturing	7,300	10,000
Wholesale Trade	10,000	15,000
Retail Trade	3,100	7,000

may be very useful in that it provides a clue to the requirement for outside funds which is most easily met in various industries. This factor is of course subject to local conditions. One bank may not hesitate to grant a loan which another might think too large. In any event the purpose for which the funds are desired, and the relationship between the scale of operations and the size of the loan appear more important than size alone.

Although the median requirements are significant, a true picture cannot be had without some idea of the distribution of loan sizes. Approximately 50 per cent of loans made in the year surveyed were from \$1,000 to \$10,000 in amount. An additional 28 per cent of the concerns borrowed in the \$10,000 to \$50,000 range, while one-sixth of those surveyed borrowed funds in excess of \$50,000.

A similar distribution of the unfilled loan demand reveals that among those unable to borrow all or part of the funds desired, a much smaller proportion of firms--about one-third--wanted loans in the \$1,000 to \$10,000 bracket and a much higher proportion--45 per cent--in the \$10,000 to \$50,000 loan class. One-fifth of the firms desired but did not receive loans in excess of \$50,000.

The larger loans obtained by established borrowers reflect the greater confidence of lenders in the ability of the older firms to service the debt. The CPA should take cognizance of this fact as well as the fact that the median

size of loans wanted but not obtained exceeded that of loans actually obtained for both established and newer firms. This latter fact was a reflection of the purposes for which the additional funds were desired. In many cases the purpose for which a would-be borrower was unable to obtain funds tended to be quite different and distinct from the uses to which loans actually obtained were applied. For the most part, the unfilled demand was for permanent capital either to fill out under-capitalized structures or for major expansions. Hence the typical unfilled amount was generally of fairly sizable proportions relative to the existing scale of operations. On the other hand most of the loans obtained were for working capital purposes, more in line with the size of the firms utilizing the funds.

The findings of the survey testify to the necessity of finding long-term funds for small business. Over two-thirds of the loans actually obtained carried maturity schedules of less than one year. At the other extreme loans made for three years or longer accounted for less than 10 per cent of the total. While short-term financing dominates the funds obtained by small business, the funds wanted but not obtained were predominantly of an intermediate or long-term nature. An almost negligible share of unfilled demand was of the short-term variety. This was so for both the new and established groups.

Banks are by far the most important source of

outside funds available to smaller sized business. Over three-fourths of all loans obtained by this group were negotiated through banking institutions. Loans from individuals were more important for the newer group than the established firms. The character of the loans obtained was largely that of the unsecured note. Over three-fifths of all surveyed loans were made without support of specified collateral. When collateral was required, fixed assets of the business were most frequently pledged.

It appears that if the CPA decides to conduct management services in the area of financial management, his most productive first assignment would be that of helping these businesses obtain intermediate and long-term funds.

Determining the financial requirements. Because in fact it is a budgeting technique, the short-term financial or cash budget was considered in the preceding chapter. In that chapter it was suggested that the determination of the short-term financial requirements of most small businesses involved simply the conversion of an estimated income statement for a future period into a statement of receipts and expenditures with special emphasis on the timing of the cash flow.

The intermediate or long-term financial needs of a business will be determined by the existence of plans for expansion. Barring any unforeseen difficulties such as the death of a partner or an uninsured casualty loss, the

future capital requirements of a business not undertaking any expansion may be met out of short-term borrowing. It has been pointed out that the majority of deserving small businesses have their short-term financial needs adequately handled by their local banks. All that is necessary is advance planning and careful administration of the proceeds, and most soundly-managed small firms will encounter relatively little difficulty in acquiring short-term funds.

If however, the small business is anticipating expansion or a large scale capital replacement program, then in all probability intermediate or long-term funds will be required. As the Department of Commerce survey pointed out, the acquisition of these funds is quite a different matter than when short-term funds are involved. Depending upon the size of the undertaking, the CPA should be prepared to assist his client in acquiring anywhere from a few thousand dollars to perhaps a million.

The determination of the amount required will depend upon the amount required to immediately finance the purchase of equipment or the building program, and the increase in working capital necessary to continue operations with the increased capital facilities. This latter factor is very often overlooked by the small businessman. He is often unaware that larger productive facilities must be accompanied by an increase in working capital if business is to proceed as before but on a larger scale. Thus, if

he is able to obtain the funds to undertake construction, he often encounters an extreme shortage of cash soon after operations resume.

Determination of the increase in working capital necessary is a difficult matter since the relationship between the cost of additional plant facilities and the new working capital requirement is not that of a simple arithmetic progression. That is, if the investment in plant is increased by one-half, the additional working capital is often more than half the old satisfactory level.

A simple method of determining the new working capital requirement is to estimate the annual sales which may be anticipated upon the accomplishment of the new investment in plant. If the management is justified in under-taking the expansion, they must have a reasonable expectation of an increase in sales. The estimated total annual sales figure is then divided by a figure which represents the turnover of net working capital that has been experienced in the past. The quotient represents the new working capital requirement. If for any reason, such as a slowing of collections or a reduction of the working capital turnover is anticipated at the larger scale of operations, allowance must be made for it. All that is left to do is provide for the additional working capital when acquiring funds for the expansion program. It is

usually better to provide for a little extra since one of the most common characteristics of small businesses in trouble is that their net worth is too heavily concentrated in fixed assets to the jeopardy of liquidity.

Methods and sources of financing. Unfortunately it appears that all too often the decision on the method by which to acquire intermediate or long-term funds is taken out of the small businessman's hands. The survey noted earlier suggested that, in most cases, it was very difficult or impossible for small businesses to obtain loans beyond the short-term. This usually leaves the small businessman, who is planning to expand, only the securities markets in which to raise funds. Chapter III pointed out that it is usually more expensive to market a small issue of stock than to borrow the funds if they are available. However, since the individual CPA is powerless to adjust any inequities in the financial markets, all he can do is facilitate the acquisition of equity capital.

This is not to say that the probable sources of long-term loans should be ignored. On the contrary, since it is usually the desire of small businessmen to borrow rather than give up part of their ownership prerogatives, the CPA must exhaust all the possibilities of borrowing before equity financing is undertaken. Thus banks, commercial finance companies, insurance companies, development credit corporations, and the Small Business Administration

should all be approached with a well prepared case for a loan. Often it is advisable to prepare a small prospectus outlining the objectives of management and the reasons for desiring the funds, as well as a detailed analysis of current financial condition. If all these sources refuse to advance the desired funds, it is often a moot question whether it is advisable to continue the effort.

It might appear that if each of the above institutions refused to grant the funds, then the risk must be too great and therefore a stock issue would also fail. Currently there is a great deal of opinion to the contrary. Much prospective legislation is dedicated to the proposition that many worthwhile investment opportunities in small business are now being wasted. In addition, a few privately endowed "venture capital" corporations such as "The Rockefeller Brothers Inc.," are being formed for the same reason. Thus the CPA would seem in many cases to have sound reasons for continuing his quest for funds after the loan sources have been exhausted.

Equity financing. It appears that in order to successfully market an issue of stock, a small business must exhibit a better than average growth potential or have been in business long enough to have established a reputation for sound, efficient management. In the majority of cases the reputation of any small business will be relatively local in scope. However, the local over-the-counter

securities markets are constantly improving so that this is not a prohibitive disadvantage. However, to the extent that any small business does not represent an extraordinarily sound risk, it should hesitate before trying to market any sort of securities issue. The CPA may be doing a real service to many small businesses by advising them to abandon such plans if in his judgment the price-earning ratio to be achieved does not justify the expense of issuance.

Not every small business is of sufficient size to raise capital in this manner. One expert has suggested that all small or moderate size firms with assets over \$250,000, and one-third of those with between \$50,000 and \$250,000, or approximately 125,000 firms in all are of sufficient size to warrant an issue of stock.⁴ This size criterion appears to be sound. In any event a CPA would be foolhardy to advise a much smaller company to undertake an issue of stock.

The company will want the type of stock which will best protect the owner's control, and raise the maximum of funds in the light of what will appeal to investors. There is no one right course for every company, but the type of stock must be selected for the particular situation. The

⁴Robert A. Weaver, "Equity Financing for the Small Firm," Harvard Business Review, (March-April, 1956), p. 91.

main possibilities for the small firm are the following:⁵

1. Straight common stock arrangements are the easiest to develop and most likely to be successful. This stock is attractive to investors because the flexible dividends promise a higher return as the company grows, and that is what investors in small companies' issues are likely to be seeking. Investors are sometimes more interested in such an issue if a warrant to buy additional stock at a specified price within a certain period is made part of the issue, as a sort of bonus or incentive.
2. An issue of straight preferred stock is rarely suitable for small companies, simply because investors feel that a fixed dividend rate does not give them a chance to participate in the company's growth, and if they want the protection that preferred stock affords because it has first call on the company's earnings and assets, they will probably prefer to invest in established large companies.

However, issuing preferred stock in a package with common stock, or with the privilege of converting to a specified amount of common stock at an attractive figure, has excellent possibilities and often appeals to the

⁵Ibid., p. 98.

investor. He has the protection of fixed earnings and at the same time a chance to share in the future prosperity of the company.

Sometimes convertible debentures are a desirable method of financing when company earnings in recent years are high enough so that the company is earning at least three, four, or five times the proposed interest charge. The underwriter can offer an interest-bearing security with common stock potential. Since the common stock into which the debentures are convertible is priced higher than it could be if it were sold outright, the company gains.

Mr. Weaver concludes that common stock is the backbone of public financing for small companies. In addition, if the growth potential of the firm is not such that as much as \$300,000 of stock can be sold successfully without jeopardizing the original owner's control, it probably is not yet ready for public financing and should try to do some private financing first.

Obviously the CPA cannot assume responsibility for underwriting the issue, so he should aid in the selection of a competent individual or firm that has experience with issues of small companies. The experience factor according to many experts is of vital importance since many features of a small company's stock issue are unique and mistakes are extremely expensive. The CPA should be ready to call in an expert, in the form of a broker or attorney, at any stage

in the public financing process where he feels unsure of his knowledge. His mistakes may be just as serious to the firm as those of an inexperienced broker. In addition, he could do severe damage to his professional reputation. If the CPA should call in an expert at some stage in the financing process, it would probably be valuable experience and he would surely know how to handle the matter the next time it came up.

In any event, it seems unlikely that the CPA will often be called upon to aid in the public financing of a small company. There are relatively few companies of sufficient size and with the requisite growth potential to make it worth while. Therefore the accountant should direct his energies to cultivating the other sources of intermediate and long-term funds for small business.

Assisting in obtaining funds. The American Institute of CPAs points out that any sort of "sales pitch" is of little use in acquiring funds.⁶ Credit men are unimpressed by even the most glowing rhetoric. They have learned from experience that money can be loaned only upon the basis of facts concerning the business. Thus the CPA's service in helping his client acquire loan funds is to undertake the

⁶American Institute of Certified Public Accountants, Financing the Small Business, (Management Services by CPAs No. 3, New York: American Institute of Certified Public Accountants, 1959), p. 44.

presentation of all the pertinent facts in the best possible manner.

Credit men take pride in the "C's" of credit. Thus, they are proud to base their decisions upon an objective analysis of "Character, Capacity, Capital, Collateral, Circumstances and Coverage." The CPA can further his client's borrowing plans by effective presentation of the tangible members of the aggregation. Bankers are impressed by the amount of personal funds an individual has invested. The small businessman must furnish a large part of the capital himself. An attitude of permanent reliance upon "other people's money" will quickly alienate any interest the bank may have in the business. The CPA might prepare a schedule detailing the date and amount of his client's investments in the business as well as the proportion of total capital supplied by the owner as evidence of his client's faith in the future of the business.

While most sound small businesses borrow on an unsecured bases, often for a first loan the bank will require the pledge of some collateral. The fact that the businessman anticipated this request by preparing a list of his business and personal assets suitable for this purpose will impress the banker. The CPA can be of service here by advising what assets the bank would find acceptable, and in some cases advising against inclusion of a particular asset, the loss of which would have serious repercussions

upon the future of the small businessman and his family.

"Circumstances" which the bank might be interested in include: (1) the seasonal character of business, (2) long-run business changes and prospects, (3) the level of community business activity, (4) the competitive position of the firm, and (5) the nature of the product. It will be relatively simple for the CPA, with his knowledge of the business, to jot down pertinent details on these matters. This act alone might make the difference between getting a loan and not, since many local bankers are highly suspicious of a business "they don't know." The fact that an independent CPA with whom they are often acquainted has analyzed the operating environment of the business will improve their receptivity. In any case, an honest presentation of this information will reduce the time consumed in investigating the business.

Finally, the matter of proper and sufficient insurance coverage is of great importance. Small businesses are subject to many kinds of losses, including those resulting from: (1) death of owner, partner, or principal stockholder, (2) cessation of operations due to fire, explosion, etc., (3) losses from theft, embezzlement, or other acts of dishonesty by owners, officers, employees, or others, (4) public liability not covered by workmen's compensation insurance.

The CPA should be positive that his client has

adequate insurance protection against any of these losses to which his business may be subject before submitting a loan application. Of particular importance to any small business is business interruption insurance. Many occurrences completely beyond the control of management could result in a financial loss greater than the client could bear if the business were shut down even for a short time. In addition, insurance on the life of the owner-manager is often of vital importance. In many cases, estate taxes result in the liquidation of the business which could have been avoided by adequate life insurance. Insurance protection against these losses is a reflection of sound planning and good general management ability which is the capacity "C". The majority of loans to small business are made on the basis of "capacity."

At this point it is clear that the CPA has much of the information that could be included in a small prospectus. In many cases, especially where a relatively large loan is required or when the business is unknown to the bank, such a prospectus will be an extremely useful tool. Additional information to be included involves:

1. The aging of receivables and details regarding any concentration in a few customers, the details of notes receivable, and the full story on allowances for bad debts.
2. Inventories, broken up by classification with

comments on their salability, and rate of turnover.

3. Investments, fixed assets, and other assets. Give market or appraisal values where applicable.
4. Budgets and forecasts. Show the lender operating forecasts and the cash flow anticipated including provision for repayment. Often it is desirable to prove the worth of the budgeting by comparison of budgeted with actual experience for prior periods.
5. Past earnings history with an explanation of any losses experienced.⁷

Preparation of such a prospectus would be fairly simple and not time-consuming. It could pay handsome dividends when applying for a loan.

Husbanding the resources. Financial management does not end with acquisition of funds from some source outside the business. The description of the financial management function at the beginning of this chapter advanced the proposition that the internal handling of financial resources is an integral part of financial management. This is often the point where an otherwise reasonably capable management fails.

If a small business is to follow a sound financial

⁷Ibid., p. 45.

policy it constantly makes an effort to insure that:

(1) The investment in fixed assets is in proper proportion to net worth, (2) Working capital is in proper proportion to sales, and (3) Cash and accounts receivable are maintained at an amount in excess of current liabilities.⁸

What constitutes a proper proportion of capital for investment in fixed assets depends upon the type of business. In most lines of industry the investment in net fixed assets is normally around 40 per cent of the net worth. A lower figure is desirable, and a higher figure need cause no concern unless it exceeds 50 per cent. There are obvious exceptions to this principal including at one extreme a trucking business, and at the other a wholesale dry goods concern or a small loan office. However, the generalization remains useful as a guide.

The chief danger involved in too heavy a concentration in fixed assets, as mentioned earlier, is simply that the enterprise may not have enough capital left to finance its current operations. Also, charges for insurance, property taxes, and maintenance not to mention time payments if the equipment is still under obligation, may become larger than can be supported if sales unexpectedly fall off. Put in another way, the well-known break-even

⁸Howard E. Kroll, Big Business Methods for Small Business, (New York: Harper & Brothers, 1952), p. 22.

point is raised dangerously high by this sort of "over-investment."

The second principle simply refers to the fact that there is a limit to the amount of business an enterprise can safely handle with the net working capital at its disposal, and any effort to go beyond this limit creates financial strains that can lead to bankruptcy. This principle was mentioned earlier with reference to the amount of working capital required after an expansion of facilities.

The point at which working capital becomes too high cannot be strictly defined. As was the case with the first principle, it depends upon the line of business. In those lines in which a rapid turnover of inventory and receivables is possible, it may be safe to operate with relatively little working capital. A dealer in perishables with a rapid collection policy would be an example of a business which could sustain a high working capital turnover. The other extreme might be an appliance dealer extensively engaged in installment selling. The CPA has only to compare the expected sales figure with the rate of working capital turnover that may reasonably be expected in order to arrive at the "safe" level for any business.

It is important to realize that any business can move from a safe working capital position to a situation where too few dollars are doing too much work simply by undergoing an increase in sales or increasing the

investment in fixed assets. Thus the CPA should be careful to caution the small businessman that these usually desirable trends often bring difficulties.

The third principle is simply another way of saying that the quotient of current assets less inventories, divided by current liabilities, should be greater than unity--the familiar acid test ratio. The principle is stated in terms of the amount of inventory on hand, because this is often the trouble spot when sales suddenly decline.

A small businessman will make an effort to maintain an inventory which will ensure quick deliveries and no lost sales. His usual effort at inventory control, if he bothers, will involve a periodic calculation of the inventory turnover, and a comparison of the result with past experience. This is not enough. Many concerns have failed because their inventories became too large, despite the fact that they were turning rapidly and therefore appeared to be in excellent condition. Actually it is likely that the fact that the inventory turnover was so excellent, persuaded the managements of these concerns that there was no financial danger in them. If a downturn in sales occurred, the inventories which had been turning well would remain on hand, in many cases furnishing the only means of meeting creditor's claims. If the business had kept a cushion of cash and good receivables in excess of current liabilities, then it would not be in trouble. However, in many cases

this hasn't been done and the business has had to liquidate because it could not sell its inventory to meet current liabilities and borrowing was impossible in such a situation.

As with each of the other principles, application of the rule concerning the relationship between inventories and net working capital requires the exercise of a great deal of judgment. The margin of working capital over inventories will vary with industry. A CPA will have to call upon all his experience in order to make useful recommendations in these matters.

An additional use of the three financial relationships just outlined is in the extension of credit. If a small business is approached by a new customer with a request for a substantial order on credit, an analysis of his financial condition in terms of the three principles is one useful criterion.

The above analysis involves three fundamental ratios which are well-known to every CPA. However, there is often a tendency to calculate the ratio for a particular business and leave it at that. This is a mistake because many of these ratios have a vast potential for improvement of the financial administration of a small business if handled properly. In order to handle them properly, the relationships underlying them must be carefully watched and allowance made for industry peculiarities. Dun & Bradstreet publish these ratios, plus the average collection period in days, for

representative firms in 54 lines of industry. This guide must be highly recommended.

Tax management. Tax management is closely related to financial management in that the over-riding consideration in each is the preservation of financial strength while minimizing the necessity of drawing upon external sources of funds. Small business is drastically in need of the same sort of attention to tax problems now enjoyed by larger enterprises. These small concerns make many important decisions without consideration of the consequences in terms of their tax liability. The CPA who comes in once a year to prepare the tax return and then leaves, is missing an important opportunity for service that is well within his present competence. He should cultivate in his small clients an awareness of the fact that tax management is an important part of general business administration.

Careful consideration of the tax consequences at every stage of business development can result in savings. When setting up a business it is the tax consideration more than anything else which often determines the form of organization to be used. If the corporate form is chosen, the manner in which it is capitalized may result in substantial tax savings over its life. Choice of a fiscal year, other than the calendar year, may reduce the burden of tax payments if not the liability for a new business.

In the day to day operations of a small business, management should consider it necessary to call on the CPA to: (1) determine the advisability of purchasing or renting land and buildings, (2) the best method of acquiring and disposing of equipment, (3) how to get income taxed as a capital gain rather than ordinary income, (4) whether it is advisable to make loans to stockholders, (5) whether accumulation of earnings should be allowed to continue, and to advise them on many other aspects of business operation which have repercussions in the amount of tax liability.

Obviously the discussion of financial and tax management just completed is by no means complete. No attempt was made to render a complete description of the services an accountant may perform in these areas. A full description of each would take many volumes. Rather, an attempt has been made to indicate that the CPA is highly qualified to advise small businessmen upon their financial and tax problems. There is a tremendous challenge for the accounting profession in this type of service. The only limitation on this type of service is to be found in the energies and abilities of the individual practitioner.

CHAPTER VIII

COST CONTROL IN SMALL BUSINESS

For most small businessmen the term cost control evokes a rather nebulous image of a series of highly complicated techniques, (supposedly used by all large, well-run businesses), which they should be using and would be if only they knew more about them. Thus, one of the first tasks of a CPA who seeks to install any sort of formalized cost control procedure will be to dispell these misconceptions. He might explain that the terms "systems engineering" or "integrated standardization" which are now popular with cost control "specialists," describe an extreme elaboration of a relatively simple system which is well within his understanding.

The small businessman should understand that the generic term cost control refers to many things. It includes the state of mind of those managers who feel a constant, constructive concern over costs. It also includes the fully integrated standard cost system, the break-even chart, and the principles of inventory management. A highly important part of budgeting is the control of cost. Similarly the principles of internal financial management are specifically oriented toward the minimization of costs. Cost control is one of the most highly integrated functions of management in the sense that if successful, such a

program will encompass every aspect of the business operation.

Most small businessmen do engage in some sort of cost control, but for the most part it is an intuitive, "trial and error" sort of thing as are many small business management functions. Probably the most important aspect of cost control is a standard by which to measure current performance. This is where most small businessmen are inadequate. It was suggested earlier that they often know too little about their own businesses. Thus the standards by which many of these people measure current cost relationships are wholly inadequate. They often exist only in the mind of the owner, and represent the distillation of past experience upon which he was not fully informed.

Comparison of the results of actual operations with standards based upon optimum conditions in the plant, presupposes the existence of some kind of cost accounting to reveal what the actual costs are, and to provide some basis for determining what they should be. If this cost accounting system does not exist, the CPA must install one. Without information on past experience, including costs and important features of the business environment in which they were incurred, the CPA would be foolhardy to try to define any standards of performance. Fortunately this sort of information is usually available in spite of the lack of a cost accounting system. Although not available

in summary form, the necessary information can often be found through a careful search of existing records. This is an excellent opportunity for the CPA to use the client's personnel and clerical staff to advantage.

If cost control can indeed be called a state of mind, it is that state of mind created by the advance planning necessary to preparation and use of standards of performance. Advance planning in cost control, just as in budgeting, forces the businessman to define his objectives and the means of obtaining them. This process will often reveal facts about costs of which the small businessman was unaware. In some cases, he will have been spending money for a purpose which did not fit in with his objectives at all. Advertising is an example of this tendency. Often a small businessman will advertise because it seems to be the thing to do, even though a moment's reflection might prove that he was not reaching the people he wished to. In this way, planning creates a wariness in the businessman which will cause him to carefully analyze any expenditure in terms of what it will do to further his objectives.

Advance planning should include more than the setting of standards. It is wise to be prepared for the inevitable setbacks which are a part of business life. This preparation should involve a determination of which items of expense the business can afford to reduce if retrenchment became necessary. The alternative is often the "panic

approach," which involves across-the-board cost cuts when sales begin to decline. These irrational decisions can be very costly.

Standard costs. The standards against which the performance of a business operation is measured are called standard costs. These are a set of pre-established costs which have been derived only after careful study and thorough investigation of ideal and reasonable material usage, labor operations and plant capacities. Such costs are indispensable to effective cost control.

The first effort to determine standard costs must rely heavily on past experience. A reasonable approach for a small manufacturer would start with a tabulation of costs for past periods, broken down by products and processes. Then a review is made of conditions which have changed to cause the material prices, wage rates, overhead costs and reasonable maximum production levels to be different from those of past periods. Adjustments are then made to reflect current conditions.

If cost records are inadequate, as suggested earlier, to the extent possible, the CPA will have to synthesize a set of standards from existing records plus his own estimates. This will involve a methodical analysis of the amount of labor, material and burden going into a product, all expressed in money terms and adjusted to current conditions. Standards should be prepared in close cooperation

with the individual who is to be held responsible for subsequent performance under the standard. In this way a more meaningful standard will be prepared, and the probability of its success will be enhanced by the assurance of cooperation from the individual who will administer the use of those items whose cost is to be controlled.

When the standards have been carefully developed, the CPA must decide whether to incorporate them into the ledger accounts or whether to use them only as points of reference against which actual costs may be compared in a periodic review of the cost of doing business. If the business is so small that it has only a single level of management responsibility, the advantages of incorporating the standards in the accounts are not great. If they are used in the accounts, the pricing process may be facilitated. However, in a very small enterprise the individual who has the responsibility for the administration of a particular standard will often be able to detect inefficiencies by close observation without the necessity of periodic information on deviations from standard. The decision on whether to integrate the standards into the ledger will depend upon the characteristics of the business, including its size and the probability that deviations from standard will be frequent and relatively large.

Which ever decision is made, the investigations and the familiarity with cost patterns that has been gained by

the preparation of the standards, will be useful. They have better equipped management personnel to detect and correct inefficiencies as they appear. In addition the statistical data is now available to prepare analyses of actual cost variations from standard at periodic intervals.

While there is value in the preparation of standard costs, their real purpose is to facilitate periodic comparisons with actual experience. A small businessman might agree to the preparation of such standards, and then through lack of knowledge or apathy toward the tools of scientific management, they may remain unused. It is an important task of the CPA preparing a cost system to be sure that management understands the importance of continued use of the devices placed in its hands.

Some system of reports showing actual cost, standard and the deviation from standard is a necessity. It is of paramount importance that any cost reports prepared for the small businessman remain as simple in design and content as is possible while still telling the story for which they are intended. Some experts suggest that the shock of seeing the deviation from what one considers a well-conceived standard will obviate the necessity of a detailed variance analysis, for the small businessman will undertake to find the source of the difficulty himself or call on his CPA to do so. Obviously this will depend upon the character and ability of the man himself. Since a

fully developed cost accounting system is too expensive for the majority of small businesses, the CPA will have to rely upon management's ability to pin-point the source of its difficulties with his guidance, thus foregoing any elaborate variance analyses. This is not as dangerous as it may sound. The typical small manufacturing operation is extremely simple in comparison with its larger counterpart.

The results of a survey of record keeping systems conducted by P. F. Lawler suggests that small manufacturers, as a result of production of few products with fewer personnel and less capital equipment, can achieve adequate control with markedly less record keeping and analysis than is possible for a larger firm.¹ This fact will make possible the introduction of the tools of "scientific" cost control on a part time basis somewhat like the concept of partial budgeting which was suggested earlier. The CPA's responsibility in this effort would be to pick the expense areas which were causing difficulty, and establish standards with which to gauge the quality of performance underlying the expense items.

The use of standard costs in the small manufacturing enterprise has been stressed up to this point. Service

¹Paul F. Lawler, "A Note on Control in Small Businesses," Harvard Business Review (September, 1947), p. 521.

establishments also have use for the technique, although not to the extent that the manufacturing enterprise does. Any repetitive procedure must have cost criteria against which its performance may be measured. The CPA should encourage the managements of small service establishments to direct their attention to the preparation of these guides.

Other cost control devices. The general effort toward cost control may be aided by the use of several psuedo-scientific devices in addition to standard costs. These include, break-even point analyses, a determination of the contribution of each product to general overhead, "manning" tables, and inventory management techniques.

Break-even point analyses are a well-known device, the utility of which lies in the necessity of classifying costs according to their variability. Obviously, if an attempt at the development of a standard cost system had been made without first classifying costs as fixed, variable, and semivariable, it would be of very limited use. In this respect it should be kept in mind that a break-even analysis is not meant to be a substitute for standard costs. It is simply an additional device for promoting cost consciousness in a small business management.

A break-even point analysis facilitates the planning function. It provides an orientation to the concept of control in that it emphasizes the importance of the

variable or controllable element of total cost, as well as the interrelations of cost, price, and volume. The graphic presentation of a break-even analysis improves the understanding of incremental analyses.

Because it is a relatively simple concept, a graphic presentation of a break-even analysis can be very useful in convincing a small business management of the necessity of cost control. It is easy to prove to a businessman that even small percentage increases in variable cost at a fixed volume will wipe out profits. At the same time, the small businessman may be thoroughly impressed by a slight downward movement of the total cost line, proving the desirability of an aggressive cost reduction program.

Any break-even point determination is clearly only as good as the classification of costs upon which it is based. It may be relatively difficult in a small business to determine the variability of certain elements of cost. To accomplish this classification, the CPA has available the scatter graph and the high-low point techniques. It is often desirable to obtain an estimation of the total of the variable and fixed elements of cost by use of the high-low point technique, and then check the accuracy of this determination by plotting the costs in the scatter graph method.

A useful method of determining the relative profitability of different products or cost centers within the

business organization is the contribution analysis. The method involves an accumulation of all the direct costs involved in production of a product or operation of the department, while leaving the overhead undistributed. In this way the contribution of each product or department to total overhead and profit is isolated. This analysis will also point out the necessity for cost reduction and control, as well as the area in which these efforts may best be centered.

So-called "manning" tables simply represent the results of an effort to define in advance the number of men required to perform each function at various levels of business activity. These tables have an important application in small business as a control device. Small businessmen are very hesitant to "let a man go" once he is hired and has established himself as part of the family. This fact, coupled with the tendency of small businessmen to over-optimism in the face of an improving sales picture, makes prior planning of personnel requirements a necessity.

For most small businesses, inventories are the most important asset, both in terms of their aggregate value and the cost of servicing them. The cost of maintaining inventories including the cost of invested capital, personal property taxes, storage facilities, insurance and obsolescence has been estimated at between 20 and 25 per cent of

their total value.² Obviously any plan by which a reduction in the amount of inventory carried could be accomplished would effect a material reduction in costs. The concept of inventory management in its highest development is part of a new science involving use of electronic computers. Fortunately there are much simpler approaches to these problems which are familiar to the CPA.

The Westinghouse Electric Corporation uses a stock control technique which is simple enough to apply to a small business.³ For control purposes they classify inventory as "protective stock" and "active stock."

The protective stock represents the minimum amount to be on hand before receipt of a new order. It is calculated by averaging the stock on hand just before receipt of five different orders. The active stock is the difference between the total average stock and the protective stock. The approximate average total stock is obtained by dividing the difference between the maximum and minimum stock, between receipts, by two. Then the total average may be calculated by summarizing the averages of the five ordering intervals. A standard order is utilized to bring

²Edgar L. Andlauer, "Inventory Management," Journal of Accountancy, (August, 1959), p. 39.

³Wilbur F. Hoehing, "Inventory Management," Studies in Modern Management No. 4, (New York: American Management Association, 1955), p. 31.

the stock up to the average total whenever the level of protective stock is reached.

The purpose of the protective stock is to provide service to the customer and factory by having stock available to meet unexpected demands. The degree of availability of merchandise can be regulated by increasing or decreasing the amount of protective stock. This is accomplished by submitting the standard (optimum size in terms of expense of storage and economies to be derived from quantity purchase) order earlier or later as determined by the anticipated demand.

This relatively simple system may be easily understood by the small businessman. Its application involves simply the determination of the optimum order size, and the average total stock, both of which are jobs for the CPA. Thereafter the small businessman need only vary the length of time between orders in terms of the expected level of demand for the coming period.

Although it appears that the techniques of cost control will be somewhat difficult to sell to the small businessman, the CPA has an opportunity for service in this area of the management function. Very often the management of a small enterprise is aware of the rising trend of its costs but does not know how to combat it. By establishing cost control techniques and a plan by which an orderly reduction in costs may be affected, the CPA can help the

small business avoid the disastrous across-the-board cost cuts which characterize a small business in a time of economic reversal.

CHAPTER IX

CONCLUSION

Budgeting, financial management, and cost control represent the principal functions of the controller which may be classified as management services when performed by an independent Certified Public Accountant. However, the controllership function is not restricted to these endeavors. It includes any of the phases of business management where fact finding and evaluation are involved. Thus, the Certified Public Accountant may perform many management services in addition to the three emphasized in this paper.

This paper examines the advisability of adopting management services as an integral part of professional accounting practice. The CPA's own professional group--the American Institute of Certified Public Accountants--has for some time sanctioned the rendition of such services, in fact, has actively promoted it. Nevertheless, as a result of misconceptions held by individual CPAs, the question of such service remains highly controversial. If management services are conceived of as purely advisory, there can be little argument with the contention that competent CPAs have a right and a responsibility to make such service available to the business community.

In consideration of the training and experience of the majority of CPAs, it is concluded that their management

services will be suitable for small business establishments that cannot afford to retain personnel to perform these specialized services on a full time basis. In order to determine if a real service will be involved in this sort of activity, the importance of small business to the American economy is questioned. It is affirmed that the many small business enterprises and their managements perform important economic and social functions in a free enterprise, democratic society.

However, small businesses are suffering from severe problems which do not allow them to realize their full potential. Chief among these problems is the inadequacy of management. This is the cause underlying the highly publicized immediate causes of most business failures. Obviously it is not enough to know simply that managerial inadequacies represent the most serious problem of small business. Planning and control are the important areas of the management function most often found lacking in small business management.

The independent Certified Public Accountant is particularly well-qualified to aid in the improvement of these two aspects of the management function. However, in his efforts to improve the quality of small business management, he must be careful not to usurp any of the prerogatives of management. His service must be of a type which will accomplish the education of the client so that he may help

himself.

There are high returns which may accrue from successful management service for both the accounting profession and the individual practitioner. The accounting profession can expect a materially enhanced prestige as well as expanded opportunities for service as a result of increased reliance by the business community upon the judgment of the CPA. The successful management services practitioner may expect an increased monetary and psychic return from the more demanding management service.

There is a definite technique to management service, parts of which are quite different from the manner in which a more traditional accounting engagement is approached. The CPA must cultivate the faculty of getting along with people if he is to overcome the many human relations problems involved in management service. He must force himself to abandon the rather secretive attitude required of him in an audit engagement in favor of full disclosure of his plans. The procedures for carrying out these plans and the conclusions drawn must be known to both the client and his responsible personnel. The presentation of his conclusions and recommendations is of greatest importance since the success of the engagement depends upon their adoption by management. If management isn't fully in favor of each of the recommendations and doesn't fully understand them, their adoption will be very unlikely. A combination

written and oral report is suggested as the most effective method of submitting the results of a management services engagement.

Budgeting, financial management, and cost control are thought to be the techniques best suited to the inauguration of management services to small business by a local practitioner. This choice is made on the basis of need by prospective clients as well as in terms of the capabilities of the CPA. It is suggested that because of the extreme importance to the profession and the individual CPA of early successes in the new field, that he go very slowly, attempting to render only those services for which he is highly qualified.

On balance there is the strongest indication that Certified Public Accountants have, in the various management services, an excellent opportunity to grow as a profession while rendering an extremely valuable service. However, they must be most careful to accept only those engagements for which they are qualified or their early efforts will be their last, and the profession will have incurred a setback which it can ill afford.

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